

United States Pacific Command

Asia-Pacific Economic Update



DISTRIBUTION STATEMENT A
Approved for Public Release
Distribution Unlimited

20020815 112

2002



Volume 1

FOREWORD

The horrifying events of 11 September 2001 have made an impact on all of us. The U.S. mainland is no longer a sanctuary. More than ever, national security starts at home. But it doesn't end there. Fortress America or isolationism is not a suitable solution. To combat global terrorism, we must be eternally vigilant at home and abroad.

At the U.S. Pacific Command, we understand that we must share our security with other Asian states and that we must cooperate with friends and partners to make the region a safer place. We also understand that international terrorists have global reach. Therefore, it's not enough for us to focus exclusively on the Asia-Pacific region. We must also have a global vision.

The same holds true in the economic arena. The United States cannot secure a prosperous world economy on its own. When the U.S. appetite for Asian goods falters, Asian jobs are lost. When Asians lose their jobs, they buy fewer U.S. goods, and U.S. jobs are lost. Therefore, we see economics as a positive sum game in which the Asian countries and the United States gain from free trade. In short, both sides value the objective of shared prosperity.

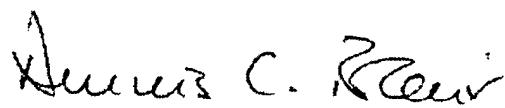
In addition, the United States and Asian countries are part of a global economic community. In this regard, we cannot ignore the financial turmoil that Argentina and Turkey face today. Asia, Latin America, and Europe faced similar financial turbulence in the 1990s. Many are now calling for a new financial architecture that would curb capital flows. In the first two chapters of our study we address this issue head-on. We systematically explore financial crises in Europe, Latin America, and Asia and develop common lessons learned. In this sense, understanding globalization enhances our formulation and execution of the U.S. national security strategy in the Asia-Pacific region.

At the same time, we also appreciate the fact that each Asian economy is somewhat unique. An IMF plan that worked in Mexico may well falter in Indonesia. Therefore, it is imperative for us to have a clear appreciation for the social and political context in which economic decisions are made in each Asian country. To capture this uniqueness, we have expanded the number of Asian economies from six in the *Asia-Pacific Economic Update 2000* to 21 in this 2002 edition. Yet we still take a careful look at the economic strategies that drove the economic performance. We analyze what went right and what went wrong with these economic strategies. If the economic performance is poor, we suggest more promising new economic strategies to generate economic growth. If the economic performance is positive, we suggest ways to sustain this prosperity.

But it's not enough for us to look at economic developments only in a social and political context. Economic developments often drive military decisions. At the same time, economic prosperity cannot take place in a war zone. If the events of 11 September have taught us anything, they have brought home the fact that economics and security are inexorably linked. For instance, money provides the oxygen for terrorist operations. We must block funds to curb terrorist attacks. In addition, we must address the environment that makes terrorism possible. Too often, poverty is a breeding ground for terrorism.

The primary mission of the U.S. military is always to fight and win America's wars. But we can never fall back into a reactive mode, waiting passively for the next military conflict to break out. We have a vested interest in preventive defense. Reducing poverty and investing more in social and economic development strengthen comprehensive security. Through our theater security cooperation programs, the U.S. Pacific Command forms partnerships with other Asian countries and organizations to provide humanitarian assistance, disaster relief, and other building blocks for economic reconstruction and development. This economic instrument of power helps to reduce the social and economic injustice that in turn fans incendiary conditions for military conflict. In this sense, building prosperity and creatively avoiding military conflict via preventive defense is far better than the most decisive military victory.

We are pleased to publish the 2002 edition of the U.S. Pacific Command *Asia-Pacific Economic Update* as a military perspective on the seamless web of economic and security interdependence.



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ASIA-PACIFIC ECONOMIC UPDATE 2002
VOLUME ONE:
ECONOMIC STRATEGY, CONTEXT, AND PERFORMANCE

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EXECUTIVE SUMMARY

Financial turmoil was prevalent throughout the 1990s. Financial crises broke out in Europe, Latin America, and Asia.

- In Europe, German economic and monetary mistakes sharply clashed with a flawed process leading to European economic and monetary unity.
- In Latin America, a high current account deficit and a rigid exchange rate regime in Mexico promoted financial chaos and a chaotic collapse of the peso.
- Similarly, high current account deficits and rigid exchange rate regimes contributed to financial turbulence and a disorderly free-fall of Asian foreign exchange rates.

Floating exchange rate regimes are needed to optimize free international capital markets.

Meanwhile, Asia's economic roller coaster shows no signs of stopping. The past five years have seen an economic crisis in 1997, recession in 1998, a bounce-back in 1999/2000, and a downturn and recession in 2001. Much of the Asian bounce-back reflected a surging U.S. economy in 1999 and 2000. But the fuel for this U.S. growth disappeared in 2001 when the global information technology (IT) sector went from boom to bust. During the boom too many Asian economies became complacent and avoided painful structural reforms. That made them increasingly vulnerable to the U.S. recession and global slowdown. Asian states will remain economically insecure until they become more serious about implementing structural economic reforms.

The terrorist attacks of 11 September 2001 worsened an already weak U.S. and global economy. After 9-11, the USG faced economic issues on at least three fronts: reconstruction in New York City, fighting recession at home, and using economic diplomacy to help the U.S. coalition in the war on terrorism. All three issues required immediate crisis action. But a long-term strategy in each area is also needed to put the United States and the global economy on a sustainable path toward long-term economic growth.

While the events of 9-11 provide common lessons learned for all the countries in the region, each country also faces problems unique to their social and political context. For instance, Australia made painful economic reforms throughout the past decade that helped the country weather the global economic storm with positive economic growth. But recent actions against foreign corporations has discouraged foreign investors and weakened the Australian dollar.

While Bangladesh still struggles with poverty, the country has also made considerable progress over the past three decades. For instance, Bangladesh is now largely self-sufficient in food production. But the country could do even better if it would improve its economic governance.

Despite strong oil sales, Brunei remains over-centralized and suffers from a lack of foreign investment in other sectors of the economy. The economy is on a recovery path as the government moves ahead with economic reforms. In contrast, Cambodia is one of the poorest countries in the world and continues to struggle. Its 4% growth rate is insufficient to make a dent in the poverty rate. Foreign aid continues to prop up the economy. But donor fatigue will set in soon and economic growth will suffer unless Cambodia gets more serious about military demobilization and economic reform.

China's economic fate is uncertain. China's WTO entry has attracted billions of dollars in foreign direct investment. Coastal commerce is booming. But state owned enterprises and the politicized banks that give them credit are like financial quicksand, dragging down the economy as a whole. The banking system would be bankrupt were it not for government largess. Unfortunately, the upsurge in government spending is not durable. The day of reckoning for decades of financial mismanagement will soon arrive unless private demand picks up.

Meanwhile, 9-11 shocked the Indian economy, although not as much as with some Asian economies. Growth continues to slow, unemployment is rising, and corporations are going out of business. Strength in the

agriculture and other domestic sectors should help a resilient Indian economy weather the ongoing economic downturn. Unfortunately, India shows no signs of addressing an alarming budget deficit that is triggering a fiscal crisis. If India is ever to reduce poverty, it must also become more serious about implementing economic reforms.

Meanwhile, President Wahid's departure and President Megawati's new economic blueprint raised expectations that Indonesia could start digging itself out of a deep economic hole. But the global recession and 9-11 shattered Indonesian exports and prospects for immediate growth.

After a decade of economic stagnation, the arrival of charismatic Japanese Prime Minister Koizumi provided a glimmer of hope that economic reform could finally take place. But the combination of a serious deflationary spiral and relentless structural problems are daunting. Reckless allocation of money over the years has created a mountain of bad bank loans. In addition, the Japanese government is running a financially unstable public sector debt of 130% of GDP. Such financial quicksand is a weak foundation for long term economic growth in Japan.

The economic situation in Laos is also grim, with Western economic assistance propping up a socialist government that shows no signs of implementing free market reforms anytime soon.

After robust growth in 2000 the Malaysian economy was virtually flat in 2001. A rigid exchange rate regime coupled with weak demand for Malaysian exports means that an overvalued ringgit is vulnerable to a sharp free-fall and financial turmoil.

While the government in the Maldives is starting to consolidate its fiscal position and address economic reform, the country remains vulnerable to external shocks because of the sluggish tourism and fishing sectors.

Mongolia's poverty-ridden economy continues to struggle despite the peaceful transfer of power in 2000. What's missing is the critical

software of society—free market laws and institutions.

North Korea's overall economic performance remains unimpressive. Agricultural production has fallen sharply and famine is possible. While there is some evidence of growth in the non-farm sector, North Korea's economic performance will be marginal at best without more decisive DPRK actions to implement a free market economic strategy. While continued donor largess is needed to keep the economy afloat, IMF and World Bank advice and assistance is also needed to move the DPRK economy in the right direction.

In the Philippines, weak external demand for Philippine exports is slowing down economic growth. A ballooning budget deficit, a large foreign debt and dangerously low currency reserves provide a weak foundation for poverty reduction and undermine the capability to fight the war on terrorism.

In Russia, President Putin has the Russian economy moving in the right direction. After a painful default in 1998 and subsequent economic downturn, three drivers—the currency devaluation, oil wealth, and structural reform—have given the Russian economy a boost.

Singapore fell into recession in 2001—its worst contraction since its independence in 1965. The crucial U.S. market for Singapore's high tech exports has totally collapsed. In addition, the weaker investment in the rest of Southeast Asia is also hurting Singapore's growth prospects.

The U.S. and global recession as well as 9-11 has sharply reduced South Korea's trade surplus and triggered a painful economic slowdown. An ill-advised U-turn on corporate reform leaves the chaebol bloated and a painful drag on long term economic growth.

Sri Lanka remains a classic case study showing the interdependence between military security and economic stability. Since military escalation in 2000, a war zone atmosphere has made economic prosperity difficult. At the same time, a weak economy makes it difficult for the government to manage the war effort.

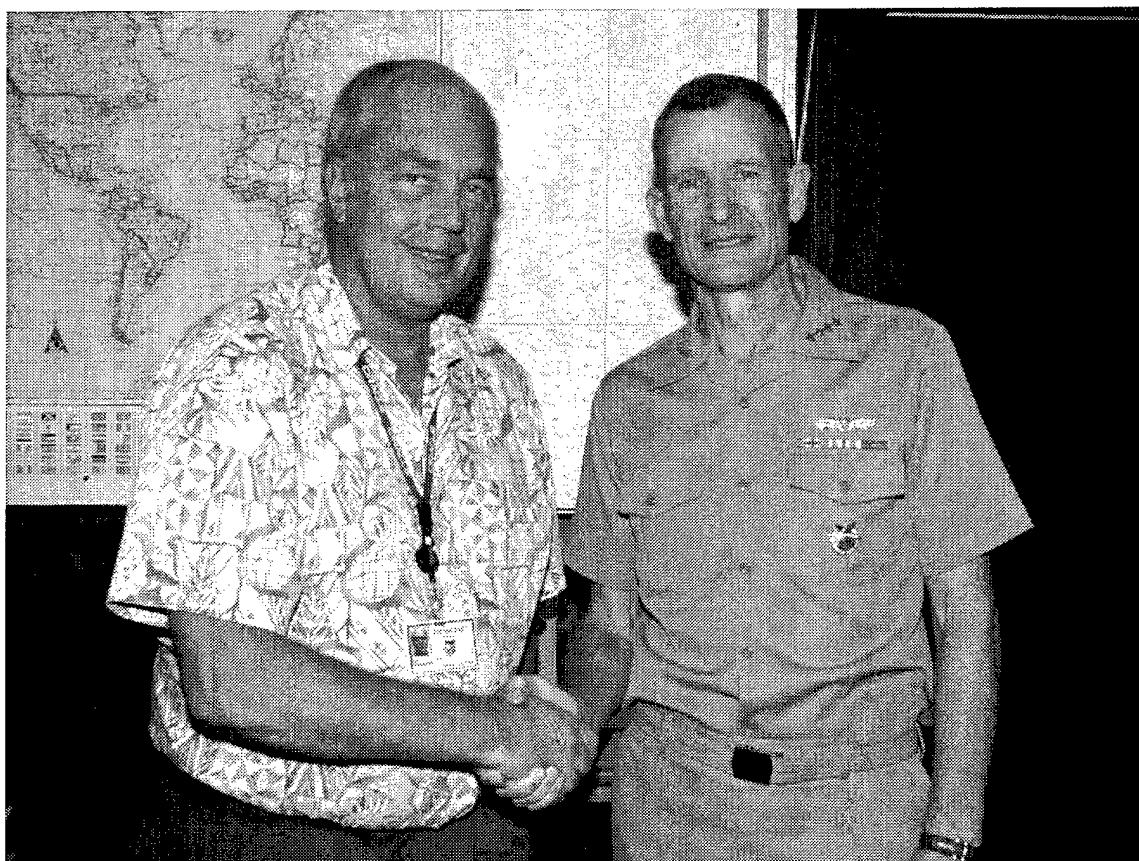
Taiwan suffered its first full-year contraction in at least half a century. Taiwan now faces three difficult economic challenges—a global IT glut, structural fault-lines (especially a broken financial system), and the mainland's investment pull (which is hollowing out the manufacturing sector).

The collapse of the U.S. appetite for Thai exports has triggered a serious downturn in the Thai economy. The most urgent problem facing the economy is a mountain of bad loans, which are dragging down the financial system. An over-borrowed public sector makes it difficult to address the banking problems.

Vietnam's economic performance remains well below its potential. Slow economic reforms continue to discourage foreign investors, which in turn keeps economic growth sluggish.

The good news is that the U.S. and global economy appear to be bottoming out. The bad news is that weak U.S. corporate earnings and a collapse in U.S. capital spending mean that it is still too early to say that a speedy and robust U.S. recovery will take place anytime soon. In this regard, the recent Enron debacle and the shoddy accounting at Arthur Anderson have undermined confidence in the U.S. business culture, thus delaying still further a U.S. recovery. Finally, a sluggish U.S. recovery weakens prospects for a strong Asian recovery in 2002.

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ACKNOWLEDGMENTS

The U.S. Pacific Command gratefully acknowledges the contributions of Mr. Mark Harstad, USCINCPAC; Dr. Clay Chun of the *U.S. Army War College*; and Mr. Brad Babson, formerly of the World Bank and thanks members of J5 at CINCPAC for reviewing early drafts of this study.

NOTES

Sources for Data Tables

Gross National Income	World Bank	World Atlas; World Development Indicators
Purchasing Power	ADB	Key Indicators
Growth (%)	CIA	World Factbook
Inflation (%)	IMF	World Economic Outlook Database
Exports	IMF	World Economic Outlook Database
To U.S.	U.S. Commerce	Direction of Trade Statistics Yearbook
Imports	IMF	Census Report FT-900 Exhibit 13
From U.S.	U.S. Commerce	Direction of Trade Statistics Yearbook
FDI from U.S.	U.S. Commerce	Census Report FT-900 Exhibit 13
In U.S.	U.S. Commerce	Survey of Current Business
Cur Account /GDP %	World Bank	Survey of Current Business
	ADB	World Development Indicators
		Key Indicators
Fiscal Balance /GDP %	World Bank	World Development Indicators
	ADB	Key Indicators
External Debt /GDP %	World Bank	World Development Indicators
	ADB	Key Indicators

SECTION I

ECONOMIC DYNAMICS

CHAPTER 1

THE GLOBAL CONTEXT: A DECADE OF FINANCIAL TURMOIL

Introduction. In early February 2002, about two thousand corporate executives, political leaders, and international economists gathered in New York City for the World Economic Forum (WEF). The decision to move the location of the WEF from its traditional site in Davos, Switzerland, to New York City was conceived as a gesture of solidarity for a city digging itself out from the terrorism of 11 September 2001.

Immediately following the 9-11 tragedy, the anti-globalization movement temporarily lost momentum. Planned protest marches on Wall Street, the World Bank, and IMF were abandoned. But recent events show that the anti-globalization movement has lost none of its passion. For instance, on 2 February nearly two thousand protestors gathered in NYC in the bitter cold to demonstrate their opposition to WEF—an evil symbol in their eyes of globalization. At the same time, another sixty thousand people congregated in Puerto Allegre, Brazil, to participate in the World Social Forum—a counter-capitalist counterpart to the WEF.

While President Bush and other heads of state, central bankers, finance ministers, and anti-globalization protesters all look differently at the U.S. and the global economic landscape, they all have good reasons for anxiety. The global economy faces great uncertainty.

The Global Economy

Globalization Fears. In the anti-globalization camp, many concerned citizens—who feel threatened by this global financial turbulence—link arms with environmentalists, trade unionists, and politically powerful Non-Governmental Organizations (NGOs).

- They want a global economy that is less turbulent. They are alarmed by what they see as clear signs that globalization is a terrible thing.
- This coalition also criticizes globalization for exacerbating a host of worries: over the

environment, labor rights, human rights, consumer rights, Asian finances, etc.

- Human rights advocates are quick to tell you that Nike exploited Third World workers by paying them dirt-cheap salaries in their unsafe overseas "sweat shops factories." American labor activists also criticized Nike for undermining economic security by "unpatriotically" exporting American jobs overseas in pursuit of greed.

Financial Globalization. Many economists in this camp are quick to blame George Soros and the Wall Street proponents of "runaway globalization" for the Asian economic crisis.

- This group sees the IMF, World Bank, WTO, and a host of other international financial institutions (IFIs) as useful whipping boys to dramatize a decade of the global financial turmoil.
- In the 1990s, exchange rate crises, stock market crashes, and severe economic contractions erupted in Europe, Latin America, and Asia.
- In 1998 the world plunged into the worst economic crisis since the great depression.
- Yet throughout most of the decade the U.S. economy seemed strangely immune to the financial turbulence.

U.S. Economic Slowdown. Then in late 2000 and early 2001, U.S. concern turned into alarm. The U.S. stock market crashed. Robust U.S. economic growth is disappearing. U.S. industrial production continues to contract. As a result, a U.S. faltering economy—previously the engine of growth in an otherwise shaky global economy of the 1990s—dragged down other economies around the world.

- The global economic slowdown turned into a global stagnation.
- The fact that much of this anemic global economy rests on financial quicksand makes a lasting economic recovery even more difficult for President Bush and other foreign leaders to navigate.
- This financial quicksand became even more evident in late 2001, when the Argentine government defaulted on its

massive debt. Argentina's rigid foreign exchange regime also collapsed.

A Financial Architecture? As President Bush and his Secretary of Treasury Paul O'Neill mull over what to do about this global financial turmoil, many responsible protesters blame the foreign exchange market and are calling for a whole new "international financial architecture."

- In fact, President Bush's predecessor, President Bill Clinton, blessed this crusade for reform of the foreign exchange market. President Clinton promised,

*"(It is now time for the world to) take the next steps (of implementing a) new financial architecture and long term reform of the global financial system. (This should include) steps to reduce the entire financial system's vulnerability to rapid capital flows and excess leverage."*¹

Back to Bretton Woods? In this regard, some say we should return to the old Bretton Woods fixed exchange rate system in order to create more financial stability and curb international financial turmoil.²

- Other observers say the world should move toward floating exchange rate system.
- Still others say each country should do "its own thing" (i.e., what's best for that country).

In any event, the single most important international financial policy decision that President Bush and other heads of state arguably must make is their choice of an international exchange rate regime that will minimize the global financial turbulence.

This chapter will look back at the most spectacular financial crises outside of Asia over the past decade, diagnose what went wrong and recommend an international foreign exchange rate regime (and domestic macroeconomic strategies) that will minimize global financial turbulence. Before we analyze what went wrong and how to get things right in the future, let's take a bird's-eye view of some of the more dramatic financial crises in the past decade.

Financial Crisis in Europe

Rise and Fall of German Optimism.

Remember the joy and optimism when the Berlin Wall came tumbling down? November 9th, 1989 was a day of euphoria in both East and West Germany. That feeling of euphoria was still evident at the time of German economic and monetary unification in July 1990 and at the time of political unification in October of that same year.

- In addition, many people envisaged this unified Germany as a new superpower, an economic powerhouse strong enough to carry not only its poor eastern cousin along with it but also the rest of what then was called the European Community (EC). In fact, German Chancellor Helmut Kohl compared German unification to a giant corporate takeover.
- Helmut Kohl did mention in passing that unification would take some time to jell. But no need to worry. The benefits would appear relatively quickly to the East Germans and it wouldn't cost the West Germans much.

After all, how could the process fail with the turbocharged West German economy behind it? Little wonder that East German expectations rose and West Germans became convinced that they need not make any real sacrifices. In fact, Kohl promised "no new taxes."

Dead-Wrong. Unfortunately, Bonn's worry-free view of German unification was dead wrong. Based on this faulty assessment, the German government consistently made one bad decision after another.

- Some of these ill-advised decisions were based on faulty economic assumptions.
- Others were taken for purely short-run political reasons.

Negative Economic Impact. The economic impact of these bad decisions made a difficult East German economic transition much worse.

- Eastern Germany became an economic black hole for Bonn.

- Henceforth, East German economic problems required the lion's share of Bonn's attention, not to mention its disposable resources.
- And as Bonn turned inward to cope with its East German black hole, its self-absorbed German policies worsened the deteriorating monetary and fiscal plight of most of its EC partners.

EC-92. This turn of events was certainly not what most people expected in 1990.

- Back then, the Kohl government was an avid supporter of EC-92, or the process of moving to a single European market on January 1, 1993.
- And as part of the overall economic integration of Europe, Bonn also strongly backed the road to European Monetary Union (EMU).
- The twin pillars of EMU were to be a European central bank and a common European currency (Euro).
- In December 1991, EC leaders signed the Maastricht Treaty that called for EMU to take place as early as 1997 but no later than 1999.

Rise and Fall of Euro-optimism. Back then almost everyone seemed to be a Euro-optimist and confidant that 1992 would symbolize EC cooperation and prosperity as well as the EC-92 milestone for a single European market.

- But 1992 was anything but a successful year for economic integration in Europe.
- In the first three years of the 1990s, financial chaos paid a visit to central Europe in the form of two currency crises.
- The exchange rate mechanism (ERM)—which linked most of the EC currencies in a tight currency band—was created in 1979 to engender stability among exchange rates.
- Instead ERM spawned two spectacular currency crises in September 1992 and August 1993 and several dozen exchange rate re-valuations.
- First the Italian lira and the pound sterling took a beating. After a hysterical defense of their currencies, the UK and Italy finally

- waved the white flag and opted out of ERM.
- Less than a year later, the French franc was hit. EC finance ministers and central bankers met over the weekend of July 31/August 1 of 1993 in a frantic attempt to save ERM. By Monday ERM was virtually dead. To save the pretense of ERM, EC leaders dramatically widened the currency band by which most of the EC currencies were allowed to fluctuate.

Financial Crisis in Mexico

Rise and Fall of Mexico. Latin America took center stage in the middle of the decade. As in Japan and Europe, we saw the big buildup for the big let down.

For Mexico, the North American Free Trade Agreement (NAFTA)—which came into force on January 1, 1994—was a glorious moment. It symbolized Mexico's new partnership with its northern neighbors. Mexico now stood proudly, on equal political footing with the United States and Canada. NAFTA also symbolized just how far Mexico had come from the agony of the 1982 debt crisis.

Mexico's economy was no longer the object of ridicule. In fact, one and all praised Mexico as building an economy that was now a haven for foreign investors.

Of course it had not been easy. Mexico's financial mistakes led to a debt crisis that devastated the economy. It took years of austere economic reforms to undo the damage. That in turn produced years of economic pain and suffering for the Mexican people. But it appeared that Mexico had finally learned a valuable lesson about the discipline needed for financial stability in the future.

By the early 1990s the bitter medicine seemed to be working. The Mexican economy seemed to be on the right path toward economic recovery. As the memory of the bad times faded, President Salinas could hold his head high. He was the toast of the continent. And so in retrospect, the economic struggle seemed worth it. In short, all was well in Mexico. Or was it?

The Peso Crisis. In December 1994 Mexico experienced a stunning currency crisis only 20 days into the administration of newly inaugurated President Zedillo.

- Just 12 short months after NAFTA came into effect, investor confidence collapsed and investors frantically sold Mexican stocks and debt securities.
- Mexico's pool of foreign currency reserves were insufficient to meet the insatiable demand of investors seeking to convert pesos into U.S. dollars.
- That triggered panic, a relentless run on the peso, and once again another devastating Mexican financial crisis.
- With the specter of national bankruptcy smacking Mexico in the face, Mexico's newly elected Prime Minister Zedillo appealed to the United States and IMF for help.
- The United States responded once again and organized a \$50B financial package to rescue the embattled Mexican economy.
- In our next chapter we'll see the parallels between this Mexican peso crisis and the fall of the Thai baht and the ensuing Asian economic crisis. But before we do this, it's important to understand the other global aspects of this financial turmoil.

Financial Crisis in Russia

Russian Meltdown. For instance, in August 1998, Russia took center stage.

- Moscow simultaneously defaulted on its maturing treasury debt and devalued the ruble.
- When the rouble was allowed to float it nose-dived to near worthlessness.
- Nobel Prize winners in economics and numerous international investors who exposed themselves to the ruble with foreign exchange contracts in the Russian debt market were soon jolted.
- Russian banks refused to perform on their forward ruble contracts when the government defaulted on its debt.

Current Financial Turmoil

As we go to press, Turkey and Argentina are simply the most recent victims of this

relentless financial turmoil that is ricocheting around the world.

- In other words, President Bush can find little comfort from this inherited legacy of global currency crises, stock market crashes, deflation, recession, public sector insolvency, and political instability all rooted in economic dislocations.
- Given this financial chaos, is anyone really surprised that a backlash is growing against global capitalism?

What's Wrong? You don't have to agree with all the signs the protesters held up in Washington, D.C. in late April 2001 to come to the obvious conclusion that something is wrong with the global economy.

- Why have these financial crises taken place?

Financial Reform? At first glance, the diagnosis and prescriptions seem deceptively simple.

- Critics of free financial markets say that the current international monetary system that permits free capital markets is "out of control."
- These critics argue that the financial crises cited above are a natural outcome for an economic system that permits the unrestricted flow of capital across borders.
- These capital flows purportedly behave more like "wrecking balls" than pendulums.
- Blame goes to leveraged speculative trading in foreign exchange and fixed income markets.
- These critics also bemoan the dearth of regulations of capital markets and the practice of letting exchange rates float freely.
- In this regard, the UN says, "the current international financial system is unable to safeguard the world economy from financial crises."³

Historical Context. In many ways, this yearning to cast the foreign exchange market in a villain's role is not new.

- President Franklin Roosevelt used to criticize currency traders on a routine basis.
- His Treasury Secretary Henry Morgenthau once said that he hoped the Bretton Woods system would "drive the usurious money lenders from the temple of international finance."⁴
- Recently, French President Chirac has criticized these international financiers.
- Malaysian Prime Minister Mahathir also shares this negative view of currency traders:

"We do not like currency traders. Do we want to see the wealth of nations built up over years be destroyed because currency traders wanted free trade? ... Whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their rich clients."⁵

Two Popular Diagnoses. To sum up, there are two popular explanations for foreign exchange rate crises:

- the speculator hypothesis and
- the capital mobility explanation.

Popular Prescriptions. At first glance, the prescription that will allegedly "cure" this "international financial disease" also appears deceptively simple on the surface.

- Recently, calls for reform have sprung up everywhere demanding the reinvention of what is termed the "international financial architecture."
- This term generally means the foreign exchange market, though it can also refer to international capital movements or by inference to the unregulated trading of large and leveraged investment funds.
- The common claim of the reformers is that changes must be made to the international monetary system to prevent the arrival of fresh waves of financial devastation.

Proposals. The proposals on the table, to name just a few, include:

- Regulation of capital flows (especially to emerging markets),
- Imposition of a tax on foreign exchange transactions,

- Establishment of target zones to limit fluctuations in foreign exchange trading and
- Policing of hedge funds and other trading concerns.⁶

If one buys this logic, how should President Bush and his economic team respond? What should be done?

- Many political leaders around the world are indicting the foreign exchange market and the system that affords mobility to international capital.
- They are urging President Bush to embrace a radical new "international financial architecture" that will "foster more financial stability."
- In other words, they are unwilling to "risk" leaving international financial matters entirely up to the free market."
- Most importantly, they recommend new rules and mechanisms to regulate the volatile international financial system.

Who can argue with this quest for more financial stability? Why shouldn't President Bush support new rules and regulations to tame and stabilize the global financial system? Isn't this open and shut case of a clear diagnosis and a logical prescription as cited above?

A Better Way. Quite the contrary. With all due respect, those people making the case for new financial rules and regulations for international capital markets do not understand what actually causes financial crisis.

- So before we risk "throwing the baby out with the dirty bath water," it is imperative that we all understand what the international capital market is and how it works.
- If we look closely at the new international financial architecture, we discover that many of its recommendations are built on erroneous assumptions.

Misconceptions. These false impressions include the following:

- Ruthless cartel of destructive speculators can hold the world ransom at will,

- Fluctuations in exchange rates serve no economic function in the allocation of economic resources but exist merely for the employment and enrichment of currency traders,
- Market economies are prone to spontaneous and unpredictable implosion simply because they are market economies,
- Foreign exchange rates bear no relation to economic fundamentals,
- Exchange rates often get "out of whack" or "overshoot" and can frequently lead to "premature" rises in the value of currencies.
- Therefore, we should return to a new international financial architecture.
- This new set of rules and regulations for international capital markets would have the world return a neo-Bretton Woods system.
- Proponents of a new Bretton Woods mistakenly think that fixed exchange rates and government management and regulation foster more "financial stability."
- An underlying and unstated assumption here is that the foreign exchange market is a private club run by "fat cats" like George Soros.⁷

Primacy of Prices. Reformers who embrace the new international financial architecture often charge that floating foreign exchange rates are bad because they produce such "undesirable" developments as "excessive volatility," and "premature movements," that often "over-shoot" their optimum positions.

- But can any serious student of economics really explain what is meant by "premature" movements in a free market?
- Would anyone ever say the price of a sweater on a department store shelf has moved down "prematurely?"
- In any normally functioning market prices move up and down in a more or less continuous basis.
- In this regard, critics of open international capital markets mistakenly perceive foreign exchange rates as "toys" for speculators.

- Fact is, exchange rates are prices, not playthings.
- When they move, by a lot or a little, it is for the purpose of achieving equilibrium between supply and demand.⁸

Normal Volatility. That said, the foreign exchange market—like all free markets—can and do go to extremes. But why is it acceptable for stock markets to boom and bust while many see it unacceptable for exchange rates to move up or down? Certainly nobody would suggest we should keep stocks frozen.

Yet many people think we ought to either keep foreign exchange rates pegged or at least have government bureaucrats guide exchange rates. This misconception raises two key questions:

- Can we really expect government bureaucrats to be more omniscient than the free market?
- Can they really dream up fundamentally acceptable levels and keep all movements in exchange rates small in magnitude?

In this chapter we'll see that government bureaucrats tend to cling to unrealistic exchange rates and invariably do more harm than good. While outside forces aggravated the situations we'll study, all of the financial crises we look at in the 1990s were invariably the result of wholly ruinous domestic economic policies rather than the fault of international capital markets.

Two Case Studies. To help us understand these realities, we will explore the economic conditions that produced financial crises in the 1990s in Europe and Mexico.

- In the process we will see how domestic economic policy blunders created these nightmarish economic conditions in Europe, Russia, and Latin America.
- The worst of these ill-advised domestic economic policies was arguably the decision by our case study economies (Mexico, Thailand, Germany, and the United Kingdom) to adopt rigid exchange rate regimes.

European Crises of 1992 and 1993

The first exchange rate crises of note in the 1990s occurred in Europe when a flawed German unity process crashed into an ill-conceived process unifying European exchange rates. The overly optimistic view the European economic and financial landscape 1990s depended heavily upon the successful economic and political incorporation of East Germany into a prosperous, united West Germany.

Curiously enough, hardly anyone questioned the premise that German unification would be economically and financially consistent with European economic integration.

- Unfortunately, the German Bundesbank would respond to the Kohl government's lax fiscal policy with an excessively tight monetary policy.
- This Bundesbank monetary death grip would trigger European recession, financial chaos inside ERM and political disunity in the EC.

First Mistake. The economic difficulties of German unification (and ultimately the rocky road to European integration) can be traced back to a number of costly German unification mistakes.

- The first mistake was in the ratio used to convert Eastern or Ostmarks into Deutschmarks (DM).
- The market value of the Ostmark before GEMU was at best only a quarter of the value of the DM. Many economists would argue that the Ostmark was really worth far less than this. Certainly a strong economic case can be made that the Ostmark should have been purposely devalued at the time of conversion to give East German exports a price advantage in foreign markets.
- Unfortunately, the German government opted to swap Ostmarks for DMs at rates of 1:1 or 2:1 depending on the transaction.⁹

Pohl's Warning. While the conversion ratio was politically attractive, it was shortsighted and ill-advised economics. The ill-fated decision might have been avoided had Bonn

consulted the Bundesbank prior to the decision. Unfortunately, no consultation took place. Shortly after Dr. Karl Otto Pohl, President of the Bundesbank, learned about Bonn's ill-fated conversion rate decision he resigned in protest.

At the time of his noisy departure, Pohl correctly predicted that the coalition government's ill-conceived mad dash to German economic and monetary unification (GEMU) would turn out to be, in his words, "a disaster." Why a disaster?

Overvalued Ostmark. In effect, the conversion ratio drastically overvalued the Ostmark, which in turn decisively overpriced East German products.

- Sadly, the German conversion rate amounted to forever pegging the Ostmark at an overvalued rate.
- The non-subsidized price of East German products then became outrageously expensive.
- In short, the exchange rate debacle left East German industries hopelessly noncompetitive, with little to export to their traditional markets.

After this German exchange rate "disaster," none of the former east European communist states complained anymore that having a "rich big brother" in West Germany gave the East Germans an "unfair export advantage!" Ironically, the conversion ratio put East Germany at a disadvantage with other east European exporters such as Poland, which purposely devalued its currency in order to keep its export prices low and competitive.

Second Mistake. Bad as this conversion ratio was in an economic sense, the mistake could have been salvaged somewhat if the conversion ratio had been offset by a reduction in prices in East Germany. A sensible policy, therefore, would have been to let East German wages fall, which in turn would serve to reduce East German prices, thus allowing East German exports to be competitive again. Instead, rising wage parity (between East and West German wages) also killed the East German corporate competitiveness.¹⁰

Wrong Assumptions. For two years the Kohl government said that unification would be relatively painless to the West Germans, that it could be accomplished quite swiftly in the east, and that the whole process could be implemented without significant tax increases. Bonn was wrong in all three areas. In September 1992, Dr. Kohl finally admitted that his economic mismanagement triggered staggering fiscal and monetary problems.

Ballooning Costs. Meanwhile, the West German corporate sector was in no position to absorb the ballooning costs of unification. Little wonder, therefore, that the burden of absorbing them fell increasingly into the western German public sector, and these costs were ballooning.

Over-borrowing. Instead of cutting unnecessary spending programs and raising taxes to pay for a large share of the DM 180B in net transfers to East Germany, the West German federal, state, and local governments opted for the old American "disease" of over-borrowing on the capital markets. Not so coincidentally, Germany's public sector deficit in 1992 matched the net transfers from West to East Germany. Back in 1993 this swelling German public sector deficit was proportionately higher as a percentage of GNP than that of even the giant U.S. public sector deficit.

Monetary Death Grip. Over-borrowing to defray the ballooning costs of unification triggered an acceleration in the German money supply. As a counterweight to this inflationary pressure, the Bundesbank opted for a tight monetary policy. Fearful of excessive monetary expansion caused by the huge cash flows to East Germany, the German Central Bank kept its short-term interest rates painfully high.

- The Bundesbank hiked short-term interest rates repeatedly.
- From the time of the fall of the Berlin wall to July 16, 1992—a period of 18 months—the Bundesbank raised the discount rate four times, starting from 6% and reaching 8.75%.
- Conflicting Interests. The Bundesbank was the anchor central bank of the EMS.

- Yet it was raising interest rates during the time when other ERM central banks were hoping to guide their interest rates to common lower levels to fight off recession.
- In other words, at a time when the Bundesbank was fighting an overzealous battle against inflation, most of the European economies were trying to fight off recession and desperately wanted to use lower interest rates as a tool in their battle.
- But since EC currencies basically were tied to the DM, no member of the ERM could decisively lower its interest rates until after the Bundesbank lowered its interest rates.
- Worse still, in order to remain in the ERM the other EC members had to adopt overly austere fiscal policies to offset the Bundesbank's tight monetary policy.

Rising Unemployment. In fact, ill-advised German economic policies hammered economic growth in Western Europe and triggered rising unemployment throughout the region.

- At a visceral level, many of the other European states understandably directed their anger at the source of the problem, the German government.
- They saw jobs lost in their countries so that West Germans did not have to pay the true costs of East Germans enjoying a lifestyle far in excess of their true productivity.

In addition to slowing down the economic growth in other European economies, the mismanagement of German unification caused havoc in European financial markets. This financial instability in turn served to undermine the confidence of international traders and therefore limited the success of European economic integration.

How did the process unravel so fast? To grasp the roots of the currency chaos in Europe that the Germans triggered, it helps to understand a little about the European Monetary System (EMS), which was set up as an antidote to the currency instability and dollar weakness in the late 1970s.

- At the core of EMS was the Exchange Rate Mechanism (ERM), a grid of exchange rate parities for participating EC members.¹¹

Financial Turmoil. The intended purpose of the ERM was to dampen the volatility of European exchange rates in the period leading up to the launch of the euro.¹² Full interest rate convergence was seen as a necessary precondition to the debut of the single currency.

But ERM was anything but a stabilizing influence.

- The ERM was a fine example of financial engineering run amok, actually induced record levels of volatility in European exchange rates.
- From the time of its inception in March 1979 until the creation of the euro at the start of 1999, the ERM suffered a total of 18 realignments affecting 56 central rates.
- It also spawned two spectacular currency crises, which we will discuss.

Why the crises? For starters, the crisis originated from a form of a fixed exchange rate regime. All the conditions that make for a potentially explosive foreign exchange regime were present.

Destabilizing Carry Trades. The first fault line was the open door for what is known as carry trades in financial circles. Carry trades attract people who have no interest in investing in the country, *per se*. They are solely motivated by a desire to use carry trades to capture the interest rate differentials between the two currencies. They express this in a number of trading strategies that go long in the domestic currency and go short in the reserve currency.

- In this regard, the ERM was the breeding ground for the most famous carry trade in history.
- In the years leading up to the September 1992 currency crisis, a massive carry trade known as the convergence play developed.¹³

ERM created serious distortions in European capital markets. Despite the apparent

exchange rate stability, European currencies featured widely disparate interest rates.

- The interest rate differentials were huge in favor of the high yielding ERM currencies against the low yielding German mark.
- Why settle for the low yield on a deutsche mark when you can get a higher yield on a peseta or a lira without any apparent compensating risk?¹⁴

Meanwhile, the market assumed that the apparent EC political commitment to EMU displayed at Maastricht meant that the EC's parities were, if anything, more fixed in the rosy future than in the last few comfortable years of ERM. In short, "all was well."

Danish Reject Maastricht Treaty. Or was it? What if this political commitment to EMU was not so rock solid? What would happen to ERM? The first indication that something might be horribly wrong with ERM occurred on 3 June 1992 when a market panic in sterling and the European bond market ensued following the defeat of a Danish referendum on the Maastricht Treaty. Investors were seriously concerned that the entire single currency project might be doomed.

In other words, all it took was the Danish vote against Maastricht in the June 2, 1992, referendum to shatter the contentment of "Euro-phoria" and European financial stability. Doubts over Maastricht destroyed the assumption that ERM parities were virtually fixed. The market then concluded that the combination of high German interest rates and several weak currencies would bring about a currency realignment. And the last thing a currency speculator wanted was to be stuck holding a weak currency after a currency realignment.

In spite of the pro-Maastricht vote in the Irish referendum a few weeks after the Danish vote, pressure began to build against the weaker currencies inside ERM. At such a critical moment in European economic integration, what European currency investors yearned for was an easier Bundesbank monetary policy to decrease the uncertainty of the French vote on Maastricht. Instead the Bundesbank did just the opposite and added

fuel to the fire by tightening its monetary policy.

By the end of August, some opinion polls said the French people would vote against Maastricht. That prospect really shook the European currency markets. Nervous currency investors were open to the idea that the Danish "no" vote could somehow be overcome. But if the French people voted against Maastricht, then the treaty would be dead. As the French referendum approached, it was clear that the vote would be extremely close. If the French voted "no," financial discipline within the ERM was sure to break down. Without the goal of a common European currency, those EC countries with weaker currencies would no longer be held to a strict monetary convergence criterion. Gone would be the outside pressure to curb budget deficits or to keep inflation under control.

Currency Time Bomb. The crisis in ERM could have been reduced if the EC finance ministers had taken decisive action and opted for a currency realignment at their meeting in Bath on September 5, 1992. Instead, the EC finance ministers equivocated.

- Not long thereafter, ERM took a direct blow when the Italian lira suffered a speculative attack, finally falling below its ERM floor on Friday, September 11, 1992.
- The Germans and the Italians met and opted for a 7% devaluation of the lira and modest cuts in short-term German interest rates to "calm" the markets.
- Inexplicably, the Bundesbank made no attempt to contact the British over the weekend about a broad realignment.
- As financial chaos spread over the next few of days, the British became livid about this incredibly callous German oversight.

The problem was that the lira devaluation alerted speculators that ERM was now unstable and recession weary countries with weaker currencies could no longer afford to use high interest rates to maintain their ERM parities. Meanwhile, the cuts in German interest rates were too little to allay the fears of European currency investors of being stuck with a collection of weak European currencies

that would quickly lose their value if the French voted "no" on Maastricht.

On the eve of the French referendum, nervous investors predictably pushed the panic button.

- They sold massive amounts of weak EC currencies and bought DM as a safe haven in a financial storm.
- By Tuesday, September 15, sterling was in serious trouble.
- It closed in London just a fifth of a pfenning above its ERM floor of 2.778 DM, its lowest ever level in ERM.
- That night sterling suffered a knock-out blow.

Black Wednesday. The stage was set for a day of carnage on the foreign exchange markets. On Black Monday the full crisis erupted two months after the final Bundesbank rate hike of 16 July 1992.

- 16 September 1992 is a day that lives in traders' minds as one of the most chaotic times in modern foreign exchange history.
- Not only was the foreign exchange market in chaos, but stock and bond markets in all of Europe were also in a complete uproar.¹⁵

Run on Pound. Massive selling of the pound sterling took place as it became apparent that the UK had made a massive error in letting a drastically overvalued pound sterling join ERM 23 months earlier.¹⁶

- In the course of one day, the Bank of England would raise short-term interest rates from 10% to 12% and then announce that it would raise rates again to 15% on the next day, all in defense of the pound.
- The UK fought the market tooth and nail, buying large blocks of its own currency against the mark.
- It didn't work.
- Sterling was being sold like water running out of a tap.

UK Opted out of ERM. Sterling was down and later completely out of ERM. Neither high interest rates nor hurling an estimated 15B pounds into the currency market had any effect. The market knew that the UK could ill

afford to keep interest rates high for long in the midst of a British recession. Nor was the UK prepared to lose all of its currency reserves simply to stay in a seriously flawed ERM.

On the afternoon of 16 September, when it became apparent to everyone that the battle was lost, the Bank of England rescinded both interest rate hikes. In the end, the UK as well as Italy surrendered and opted out of ERM and the cause of European integration was dealt a serious blow. In fact, the UK still has not returned to the single currency as of May 2001.

Moreover, the financial costs of the crisis were staggering. Despite heavy Bundesbank intervention, Italian reserves were decimated. Moreover, Anglo-German diplomatic relations was damaged still further by the seeming indifference of the Bundesbank to the British financial crisis.

The French "yes" vote in September 1992 and the Danish "yes" vote on May 18, 1993 saved EMU from disaster. But ERM was another matter. It was hardly the zone of monetary stability it was supposed to be.

Second Crisis. Eleven months later, in late July/early August 1993, a second ERM crisis occurred.

- This time the primary targets were the French franc and the Italian lira.
- The catalyst was the Bundesbank's refusal to lower its discount rate at its meeting on July 29.
- The attack on the franc and other weak EC currencies still in ERM was reminiscent of the attack on the British pound and the Italian lira on Black Wednesday in September 1992.
- EC finance ministers and central bankers met in an emergency meeting over the weekend of July 31/August 1.
- By Monday ERM was virtually dead.

Wider ERM. To save the pretense of ERM, EC monetary and finance leaders decided to widen the ERM currency band.

- They widened the margins by which seven of the EC currencies, including the French

franc, would be allowed to fluctuate by 15% above or below their nominal exchange values (instead of 2.25% for most of the currencies previously).

- Even with these measures, Spain and Portugal, were forced to devalue one last time on 6 March 1995.

Eventually the European currencies did stabilize and convergence was achieved. But this happened after the 2 August 1993 widening of ERM trading bands to plus or minus 15%. So was ERM really in the interests of the Europeans to have created? In DeRosa's words,

"Convergence was achieved not through manipulation of exchange rates but as a natural result of improved economic conditions ... Neither of the ERM crises would have occurred had the EMS not insisted on trying to limit the fluctuations in exchange rates inside Europe. The whole episode should have argued for an open-and-shut case for the economic incompetence of the European ministers who designed the ERM.¹⁷

Mexico

But if European financial turmoil was spooking investors, the situation in Latin America seemed to be better, especially in Mexico. By the 1980s, Mexico appeared to be transforming its economy into a respectable emerging market success story. NAFTA became effective on 1 January 1994. Things were looking up. But in economics, appearances can be deceiving.

In December 1994 the Mexican peso suddenly was the target of tremendous selling pressure. In a matter of days, the peso declined to less than half of its previous value against the dollar. How could things unravel so fast? The Bank of Mexico would have everyone think that Mexico was a helpless victim of speculative attack and an unjust foreign exchange market. But basic economic analysis argues differently. The fall of the peso was actually due to real economic forces. In other words, the Mexican economy was in far worse shape than it appeared on the surface. And many of the ghosts that

haunted Mexico in the past were reappearing in 1994.

An Overvalued Peso. A fatal flaw in Mexico's economic formula began with Mexico's foreign exchange regime. Mexico made the mistake of trying to use a de facto fixed exchange rate regime to "stabilize" the economy. Mexico's "crawling peg" fixed exchange rate regime allowed for only a tiny depreciation over time. The government tried in vain to lean on a virtually fixed exchange rate regime as an "anchor" that would somehow offset inflation, an undisciplined fiscal policy, and an unpredictable climate for foreign investors.

But try as it might, the Bank of Mexico just couldn't get the value of the peso right. It was consistently and sharply overvalued. While the Mexican exchange rate regime was becoming less rigid between 1988 and 1993, it was still not nearly flexible enough to accommodate an inflation rate that was much higher than that of the United States. In Rudi Dornbusch's words:

By 1993, Mexican producer prices had risen in dollars by over 45% since the late 1980s compared with prices in the United States. An overvaluation of at least 25% could be discerned. Growth slowed down (except for election year spending), real interest rates were extremely high ... and the external balance shifted towards a massive (capital account surplus).¹⁸

Given the importance investors attached to the apparent stability of the Mexican exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

- At about three pesos to the U.S. dollar, the peso was still drastically overvalued (by 30-40 percent) in 1994. That meant Mexico's trade deficit was in big trouble.
- If we look at the more inclusive current account (which includes trade in goods and services), Mexico's deficit had risen to 8% of GDP by 1994. That number was dangerously high by any country's standards.
- There was remarkable complacency about the fact that Mexico's current account

deficit had steadily risen from \$3.8B in 1988 to \$29.5B in 1994.

Impact on Prices. The overvalued peso had severe consequences. It became cheaper to cross the border and buy groceries in Texas than to buy them in Mexico. So Mexican consumers soon became addicted to buying more and more imported goods from the United States.¹⁹

Trade Imbalance. To cover this trade gap, Mexico had to import more and more foreign capital. This made Mexico's balance of payments increasingly vulnerable if for any reason investor confidence in Mexico began to get jittery or if investors saw better opportunities elsewhere. For awhile in the early 1990s, the large current account deficit was a difficult but manageable problem.

Capital Inflow. That's because capital literally poured into Mexico in the early 1990s.

- During the 1990-93 period, IMF estimates that Mexico received \$91B in net international capital flows, with \$30B flowing into Mexico in 1993 alone.
- That amounts to roughly one-fifth of that garnered by all developing countries combined.
- But all capital inflows are not the same. For instance, a large chunk of the capital was portfolio capital (stocks and short term bonds) or "hot money" which can leave the country at the speed of light.
- In fact \$61B of the \$91B in net foreign capital inflows into Mexico was in the form of hot money.

Addictive Carry Trade. Why was so much capital coming into Mexico? To maintain the virtually fixed exchange rate against the U.S. dollar, the Mexican government had to push interest rates far above U.S. interest rates. As a result, dollar investors soon became addicted to a carry trade involving peso-denominated short-term government debt issues, known locally as Cetes.

Cetes. These Cetes offered a large step-up from U.S. dollar interest rates with no apparent risk.²⁰ The common wisdom in financial circles was that the probability of a large devaluation was low. In fact, a

devaluation had not taken place for a long time. So a substantial incentive remained for foreign investors to hold pesos as long as they believed that the fixed exchange rate regime could be preserved. The game for any market player was to time the conversion of funds back into dollars before the devaluation and obtain higher than the market return on the dollar.²¹

False Indicator. Meanwhile, the Mexican government kept up the trendy economic fallacy that massive amounts of capital flowing into Mexico was somehow a positive sign of "confidence in the economy." Nothing could be further from the truth. Countries like Mexico that have large inflows of foreign capital are frequently not marching toward prosperity. Too often, they are actually courting disaster. The fixed exchange rate regime in Mexico triggered what economists call a gross economic distortion. Or as Rudi Dornbusch puts it, "All the symptoms of a troubled financial situation were in place."²²

Earlier we saw that carry trades attract people who have no interest in investing in the country, *per se*. They are solely motivated by a desire to use "carry trades" to capture the interest rate differentials between the two currencies. DeRosa is even more blunt about this grim reality.

Rat Hole. As far as investors cared, the capital flowing into Mexico might as well have been going down a "rat's hole." The entire incentive for investing in Mexico rested on the preservation of the artificially stable exchange rate, rather than on carefully scrutinizing real economic opportunities in Mexico.²³

Given the importance that investors attached to the apparent stability of the exchange rate, surprisingly little attention was given to the fact that the peso was massively overvalued prior to the crisis.

Wishful Thinking. Why didn't foreign investors realize that huge blocks of foreign capital that were stampeding into Mexico might someday turn around and try to leave en masse. Not to worry. The risk of forced devaluation seemed remote. Even if foreign investment fell a bit, Mexico's foreign currency

reserves were relatively plentiful, at least for awhile. In fact, Mexico's foreign currency reserves increased dramatically from \$6.3B to over \$25B between 1990 and 1993. These reserves gave the government a false sense of security. Consequently the government ignored the current account deficit time bomb. And if worse came to worse, the U.S. government or the IMF would probably bail out the investors. As Paul Krugman puts it, "Heads they (the investors) win, tails they win."²⁴

The Tide Turns. Mexico's worst fears would soon become a reality. It was bad enough that Mexico's own policies were self-defeating. But by early 1994, the U.S. economic recovery was galloping along. Afraid that this recovery might overheat the economy, the U.S. Federal Reserve started to tighten monetary policy. On 4 February 1994, the Fed hiked interest rates by 1/4 point to counter inflation in the United States. This was the Fed's warning shot. Over the next nine months, the Fed raised the Fed Funds Rate six more times. In the course of the year, the Fed hiked short-term interest rates by a cumulative total of 300 basis points. The final rate hike, of 75 basis points, occurred on 15 November.

Fed Tightens. The Federal Reserve's decision to tighten monetary policy in 1994 is an example of how a policy of a large country can have disastrous indirect and unintended consequences for a smaller neighbor. How much of the peso crisis ought to be assigned to the actions of the Fed? Certainly the Fed's action made it increasingly attractive for investors to chase high interest returns in the United States. That added yet more pressure on the peso, since the peso was pegged to the dollar.

As rising interest rates in the United States began to approach interest rates in Mexico, Wall Street analysts started to tell their investor clients that they could get almost as much of a return on U.S. securities without the risk of Mexico's political instability. Slowly but surely, investors in 1994 started selling peso assets and buying dollar assets.

Chiapas Revolt. Meanwhile, this Fed move could not have come at a worse time for Mexico. A number of other ruinous influences started to heat up that were unique to Mexico at the time. Chief among these internal factors was an acute loss of confidence in the political stability of Mexico. A peasant revolt in Chiapas and the political assassination of Mexican presidential candidate, Luis Donaldo Colosio, caused investors to get jittery about political unrest.

Electoral Economics. Of course, the Bank of Mexico could have matched the Fed's interest rate hikes and kept the lion share of investor money in Mexico. But politics was more important than financial stability to the leaders of Mexico's PRI political party during the first half of 1994. And the logical way for the PRI political party to get re-elected in August of 1994 was to spend money like crazy just before the election. That meant loose fiscal and monetary policies. This quick economic jolt would turn into votes for the PRI.

To make this happen, the Mexican government also announced that privatization and other tough economic reforms would be delayed until after the election. The PRI political operatives figured there'd be plenty of time for a newly elected Zedillo government to "clean up" the financial mess and downward pressure on the peso after the election.

Tesobonos. Zedillo was sworn in as president on 1 December and trouble arrived on his doorstep immediately. In an attempt to boost investor confidence, the Salinas government (which governed before Zedillo) decided to reconfigure the structure of the government debt by introducing a new form of government bond called tesobonos in April 1994. Tesobonos were short-term debt securities that paid in pesos but were indexed to the U.S. dollar. In doing this, the Mexican government effectively issued U.S. dollar denominated debt. In other words, the lower the value of the peso relative to the U.S. dollar, the more pesos the government would owe to the tesobono holders to preserve the dollar value of the debt. By November 1994, 50% of the government debt (or \$24 billion) was in the form of tesobonos.

By December 1994, tesobonos represented 2/3 of the Mexican government debt. Financial crises often have their unique signature policy initiatives that go wrong with disastrous consequences. With Mexico, it was the decision to issue the tesobonos. These bonds, being dollar linked, effectively created a financial doomsday machine in the basement of the state treasury. As the crisis progressed, the deterioration in the value of the peso was matched by an upward revaluation of the domestic currency value of the debt. The feedback loop was that as the peso weakened, the government's tesobono debt increased, which in turn put more downward pressure on the peso.²⁵

Financial Chaos. And instead of tightening monetary policy by raising interest rates before the election, the Mexican government did just the opposite and began to ease monetary policy in March of 1994. To stimulate economic demand prior to the election, the politicized Mexican central bank dropped interest rates from a peak of 18% in April 1994 to about 14% in August, even as rates rose in the United States and the rest of the world. That spooked the Mexican bond market and billions of U.S. dollars poured out of Mexico and into the United States. Mexico's foreign currency reserves dropped from \$25B in 1993 to around \$14B by mid 1994.

Thus, Mexico's overly rigid exchange rate regime fatally clashed with its loose monetary and fiscal policies. As the August 1994 election approached, Mexican authorities were reluctant to take actions in the spring and summer of 1994, (such as raising interest rates or responsibly devaluing the peso) that could have reduced this disconnect and avoided the peso crisis. This fundamental policy disconnect was exacerbated by the Mexican government's dithering non-response to several economic and political events.

Run on Pesos. That gave the impression to foreign investors that the Mexican government really didn't know what it was doing. And so investors responded to this financial incoherence by massively selling peso denominated assets and returning to the safe-

haven of U.S. dollar investments. When the turmoil struck on December 20, 1994, the government's initial reaction was to defend the peso. The Bank of Mexico reportedly lost \$4B intervening to support the peso between December 20 and 22. On December 22, Mexico announced that the peso would be devalued by 15%. It was too little, too late.

Peso Floats Down. Two days later, the selling pressure on the peso was so massive that the government was forced to abandon the fixed exchange rate regime and let the peso float. To make matters worse, the value of Mexico's dollar-linked tesobono debt increased sharply as the peso depreciated. In addition, the depreciation of the peso and the associated rapid rise in domestic interest rates increased the amount of non-performing loans in the Mexican banking system, in part because most loans in Mexico have floating interest rates that quickly reflect market rates.

Tequila Effect. Shortly thereafter, Latin America experienced the "Tequila Effect." The spillover effects largely were confined to Argentina and Brazil. Both stock markets fell. But the largest and most ominous spillover effects to hit Argentina and Brazil came in the foreign exchange markets. Over a three-month period, Argentina spent one-third of its reserves trying to defend its fixed exchange rate regime.

U.S. Bailout. Finally, Mexico ushered in the era of the great supranational crisis bailout program. On 2 January 1995 Robert Rubin, the U.S. Secretary of Treasury, announced an \$18B international credit package for Mexico. Later that month President Clinton announced a multilateral assistance package for Mexico that totaled nearly \$50 billion. At the time this qualified as the largest financial bailout in history, a dubious honor that would soon be conceded to Southeast Asian nations.

This U.S. government sponsored bailout of the Mexican economy also represents merely another dangerous form of market distortion. When investors come to expect that they can fall back on the U.S. treasury or the IMF to come to their rescue, they stop trying to make careful judgments. In this kind of moral hazard, investors participated in high-risk

ventures in Mexico, with little or no economic or social responsibility. They put capital into Mexico only because of the existence of an actual or implied government guarantee of return of principal.

It's time to get rid of such blatant "corporate welfare." In this regard, a number of serious questions are raised by the Mexican bailout. For starters, who exactly got bailed out? The holders of the tesobonos, many being foreign investors and non-Mexican banks, got relief while the ordinary citizens of Mexico were left to suffer economic recession. That's outrageous. As DeRosa points out:

"The case of having free markets rests on the premise that there be a connection between choices and outcomes. Investors need to enjoy the rewards from having taken risks and having made intelligent, informed decisions. Conversely, it is also necessary they suffer disappointment when their choices turn out to be mistakes. Otherwise capital will be allocated to unwise investment projects."²⁶

In this way, the Mexican peso crisis bailout of 1995 only accelerated the irresponsible flow of international capital into the economies of Southeast Asia. Unfortunately, none of the Southeast Asian states were watching the Mexican experience. Such inattention would soon haunt the Asian tigers.

Endnotes

- 1 Beckner, Steven, "Clinton: Prepares Way For Proposals for Financial Architecture Reforms," *Market News International*, April 20, 1999.
- 2 Robert Gilpin, *The Challenge of Global Capitalism*, 2000.
- 3 United Nations, *Report of the Task Force of the Executive Committee on Economic and Social Affairs*, 1999.
- 4 Henry Morgenthau, Closing Address to the Bretton Woods Conference, July 22, 1944.
- 5 David F. DeRosa, *In Defense of Capital Markets*, 2001.
- 6 *Ibid.*, 12.
- 7 George Soros reportedly made a profit of \$1B in a one-way bet by selling the pound sterling short.
- 8 DeRosa, *Ibid.*
- 9 The average worked out to be around 1.8:1.
- 10 For a discussion of this important wage parity mistake, see Leif Roderick Rosenberger, *How German Unification Mistakes Damage West European Economies*, Strategic Studies Institute, U.S. Army War College, 1993.

11 ERM began in March 1979 with eight currencies (the DM, French franc, the Belgian and Luxembourg francs, the Dutch guilder, the Danish krone, Irish punt and Italian lira). Spain joined ERM in June 1989, followed by the UK in October 1990 and Portugal in April 1992. Of the 12 EC members, only Greece chose not to join, largely because its inflation rate was too high to stay in such a relatively tight currency band.

12 Each ERM country was assigned a targeted exchange rate with respect to the ECU called its central rate. Each participating country was responsible for maintaining its currency position with the grid within a tolerance of a predetermined band. Prior to August of 1993, the ERM grid limited the movement of the stronger EC currencies to 2.25% either side of agreed bilateral central rates. The currencies of the weaker economies (Italy, Spain, Portugal and the UK) could fluctuate up to 6% on either side.

13 The ERM carry trade – known as the “convergence play” was expressed with long positions in high-yielding Italian and Spanish debt hedged with short positions in the lower-yielding German mark. Speculators would profit from the high yields on Italian and Spanish paper while using the lower yielding German mark, the anchor reserve currency in ERM, to hedge the currency risk of the lira and the peseta. As long as the ERM held together, meaning no substantial devaluations of the lira or the peseta, the trade made money. It was like getting free interest. DeRosa, p. 59.

14 The attraction of the convergence play was virtually universal. It amounted to government sponsored arbitrage. The ERM was the catalyst money market mutual funds that specialized in the short-term securities of foreign governments with high interest rates. Morningstar, Inc estimated that over \$20B of investor money flowed into these funds between 1989 and 1992. The main engine of portfolio performance for these funds was the convergence play. The IMF estimates that the total of such convergence plays could have been as high as \$300B.

15 Above all, it was the day of reckoning in financial markets for carry trades known as the convergence play, cited earlier. The exposure for the investor was the cross-exchange rate between the lira, the pound and the peseta against the German mark. When the pound, lira and the peseta were sharply devalued, as were the ERM currencies during the crises of 1992 and 1993, investors suffered huge exchange rate induced capital losses. It was only then that the true risk of the convergence trade became widely appreciated.

16 The crisis featured the famous episode in which George Soros reportedly made \$2B from a short sterling/mark position.

17 DeRosa, *Ibid.*

18 Dornbusch, "The Folly, The Crash and Beyond: Economic Policies and the Crisis," in *Mexico 1994: Anatomy of an Emerging Market Crash*, Carnegie Endowment for International Peace, 1999.

19 In this sense, Ross Perot was ill-advised. In reality, the "great sucking sound" was Mexican consumers importing huge amounts of U.S. goods into Mexico.

20 In January 1994 the alluring spread between the Cetes interest rate and comparable U.S. dollar rates was 6.22%, annualized. By July 1994 the spread between the Cetes rate and the U.S. dollar rates had risen to 9.94%. The spread closed to around 7% in early December before the crisis.

21 DeRosa, *Ibid.*

22 Discussions with Professor Dornbusch at his Seminar on International Economics, MIT, Spring 1997.

23 DeRosa, *Ibid.*

24 Discussions with Paul Krugman at MIT during the Spring of 1997.

25 DeRosa, *Ibid.*

26 DeRosa, *Ibid.*

CHAPTER 2

THE ASIAN CONTEXT: FINANCIAL TURMOIL

Introduction. Not to be outdone by financial turmoil in Europe and Latin America in the 1990s, Southeast Asia took center stage in 1997. But who would have predicted it? As we look back at the Asian economic crisis, the words from Charles Dickens' *A Tale of Two Cities* come to mind, "It was the best of times, it was the worst of times." While the words once described France on the eve of the French Revolution, these same words could just as easily be used in 1997 to describe the rise and fall of the economies in Southeast Asia.

Just a few years before, the World Bank singled out the economies of the Asian tigers as models for long term economic development. The World Bank published a book entitled *The East Asian Economic Miracle*.¹ It seemed like "the best of times."

Financial Nightmare. Unfortunately, 1997 was a nightmare for the region. In July of 1997 currency traders savagely attacked the Thai baht. Before long, the currency crisis spread across Southeast Asia. After forcing an 18% devaluation of the Thai baht on 2 July, currency speculators quickly turned on other neighboring countries linked to the U.S. dollar. Before long, Indonesia, once the darling of the IMF and World Bank, had to approach these Bretton Woods twins for an embarrassing rescue package of its own. By December 1997, South Korea was on the verge of national bankruptcy. They faced a foreign exchange crisis, stock market meltdown and a bank panic. Like Thailand and Indonesia, South Korea had to go to the IMF at the 11th hour to fend off financial disaster.

During the first half of 1998, the crisis-hit Asian countries went into a deep recession. Indonesia went into a depression with about 15% unemployment. But the worst was yet to come for the global economy.

Setting the Stage

Stable Currency Mindset. During the best of times, most of the Asian tigers believed that a rock-steady currency was the fundamental

foundation for their economic success. For over a decade they generally held their currencies stable against a basket of currencies dominated by the U.S. dollar. Currency stability inspired confidence among traders and foreign investors. Economic relations with them consequently appeared to be relatively risk free. For much of the decade running from 1985 to 1995, Japanese manufacturers, in particular, saw Southeast Asia as an attractive production refuge from a strong yen. Southeast Asian currencies virtually pegged to a weak U.S. dollar gave tiger exports a competitive shot in the arm.

Capital Inflow. In the boom years of 1994 and 1995, weak currencies attracted huge capital inflows. Much of it was Japanese money. But despite these capital inflows, tiger governments, anxious to maintain price advantages for its exports, generally resisted pressure for their currencies to appreciate against the dollar. The result was an unhealthy surge of domestic liquidity. The combination of high national savings and large capital inflows produced huge pools of financial capital, which tiger businessmen used to drive the economic growth. Add cheap labor to the mix and it's little wonder that this economic formula helped the manufacturing exports of the Asian tigers grow by leaps and bounds.

Over-Valued Currencies. The flip side of weak tiger currencies (which were making their exports so attractive) was a strong yen that was undermining the export competitiveness of Japan. In November of 1994, U.S. Treasury Secretary Robert Rubin replaced Lloyd Bentsen's weak dollar policy with a strong dollar policy. After the dollar hit a rock bottom 79.70 yen to the dollar rate on 18 April 1995, the G3 (the United States, Germany and Japan) collaborated and pushed the dollar up 40% against the yen between 1995 and 1996.² Since tiger currencies were generally pegged in a de facto sense to this rising U.S. dollar, the price of tiger exports became less competitive in 1996 and 1997.

PRC Devaluation. Meanwhile, in January of 1994 China devaluated its currency (the yuan)

50% against the U.S. dollar. That gave China the potential to radically under-price the manufactured goods of the Asian tigers. This new export price advantage (plus the new export capacity China was bringing on stream) hurt tiger exports in 1996.

Collapsing Exports. As a result, almost all of the Southeast Asian exports began to stumble in 1996.³

- For instance, the contrast between Thailand's merchandise export growth in 1995 (25%) and Thai export growth in 1996 (0%) was startling.
- This zero Thai export growth in 1996 pushed the Thai current account—which measures trade in goods and services—into a huge deficit of 8% of GDP.

Currency Vulnerability. Given these trade difficulties, Wall Street and other financial capitals perceived the currencies of the Asian tigers as overvalued. And the more overvalued a currency, the greater the perception that this situation is unsustainable and the greater the incentive for speculators to attack it.

Relaxed About Trade Deficits. Why weren't the tigers more concerned about the high current account deficits? Their leaders conceded that large current account deficits could be a bad thing. But they made the logical economic argument that if a current account deficit mostly reflects higher investment, it will eventually increase an economy's competitiveness, and therefore its ability to repay the debt, and will certainly be more sustainable than a deficit driven by consumer spending.

"We're not Mexico." Tiger leaders were also quick to contrast their investment oriented current account deficit with Mexico's consumption driven current account deficit. In the four years prior to 1994, four-fifths of the increase in Mexico's current-account deficit reflected lower savings and increased consumption. In contrast, the widening deficits of most of these Asian economies reflected higher investment, not consumption.

On the surface, all of this made perfectly good sense. But the underlying assumption here

was that most of this "investment" spending was intelligent and potentially profitable. Unfortunately, nothing could be further from the truth. As our story unfolds, we will see that much of the so-called investment was foolishly spent on an oversupply of property development and redundant manufacturing capacity rather than improving the quality and competitiveness of tiger exports.⁴

Wishful Thinking. In addition, tiger leaders generally dismissed the zero export growth as primarily "cyclical," reflecting potentially reversible factors such as the weak demand in Japan and Europe and the rising U.S. dollar. They hoped that both factors would somehow turn around in 1997. Such wishful thinking was no substitute for a coherent strategy and would come back to haunt them in the months ahead.

Rigid Model. Meanwhile, the rigid economic model of the tigers made it increasingly difficult for them to adjust to the new realities of a rising current account deficit.

- If the tigers had been in a floating exchange rate system, the large current account deficit would have caused the baht to gradually depreciate.
- A weaker currency would have increased the demand for their exports and decreased consumption of imports.
- That in turn would have lowered the current account deficit and made it possible for them to balance their payments without the need for huge (and potentially destabilizing) capital inflows.

But even when the financial crisis became impossible to miss, tiger governments still had a rigid mindset about stable currencies being the centerpiece of their economic success in the previous ten year period. Conditioned by years of rote learning and bound in their mental straightjackets, it was impossible for tiger leaders to imagine economic success in a floating exchange rate system.

Thai Nightmare. The tiger fixation with stable currencies was particularly true in Thailand. In a country with more than its share of political and economic turmoil, the currency peg seemed to many as the only stable thing

left in Thailand.⁵ Consequently, the Thai government refused to let the baht adjust to a 40% rise in the dollar against the yen from 1995 to 1996, despite a rising current account deficit. Given the Thai determination to keep the baht stable, a way had to be found to prop it up and counter the downward pressure on the baht from the large current account deficit. Bangkok's fatal "solution" was to raise domestic interest rates to punishingly high levels. These high interest rates hammered the economy in a number of ways.

Thai Carry Trade. For starters, the high interest rates encouraged a Thai carry trade known as the "Thai baht basket trade." This financial gig consisted of borrowing in dollars, marks or yen to finance investments in Thai baht bonds or baht bank deposits.⁶ Another causal factor was the role that the baht carry trade played in the buildup to the crisis. Massive baht positions had accumulated solely because of the presumption that the bank's peg for the currency would endure. In February 1997, the spread between Thai baht interest rates and the Bank of Thailand's basket (dollars, yen, and marks) ranged between 500 and 600 basis points. The Thai baht carry trade, in all of its variations, involved being long on the baht and short on dollars, yen and marks.

Worsens Property Glut. In addition, the high interest rates exacerbated problems in the property and banking sectors, clobbering property developers and making it virtually impossible for many to pay loans back to their banking creditors. At the same time these non-performing loans began to pile up inside the banks, high interest rates were also deflating the value of banking assets, thus crippling the solvency of the embattled financial sector. That caused corporate earnings and stock prices of Thai financial companies to plunge.

Over-priced Exports. High interest rates also hurt many manufacturers. It artificially strengthened the baht, which in turn made exports less competitive. The high interest rates also caused Thai consumers to be more spendthrift, which in turn shrunk aggregate demand at home. That caused the economy

in 1997 to a grind to a virtual standstill. As the liquidity and asset problems of banks and corporations began to multiply, they turned to the Thai central bank for relief. Unfortunately, the central bank had to tell the business and banking communities that there simply was not enough money to go around.

Cheap Foreign Money. The punishingly high interest rates made it a non-starter for Thai businessmen to borrow money at home in baht. That prompted increasing numbers of Thai borrowers to go overseas for cheap capital. Thai financial firms assumed it was perfectly safe to take out foreign loans for their Thai business clients.

Capital Inflow. The result was a flood of cheap foreign money that allowed banks to make foreign currency loans in dollars at interest rates far lower than loans in baht. In the two-year period from 1995 to 1996, foreign borrowing by Thai financial firms almost doubled. By 1996 Thai companies and individuals had piled up huge dollar debts. In fact, by 1996 they owed more than \$70B. That figure amounted to half the GDP of the country. Thus a gigantic stock of dollar-based indebtedness massed in Thailand in the years leading up to the crisis of 1997, putting the country in a very dangerous position. Effectively, the Thai government balance sheet was long their domestic currency and short dollars, all based on a wing and a prayer that their fixed exchange rate regimes would endure. This huge capital inflow covered the current account deficit in the Thai balance of payments. Problem solved? Not exactly. On the surface, all was well. But not all capital inflows are the same.

Hot Money. Had Thailand been receiving a lot of foreign direct investment, this relatively "permanent" money would have contributed to financial stability. Instead, Thailand was using a dangerously high percentage of short-term capital or "hot money" to cover its current account deficit. If financial stability had been a Thai goal, such hot money flows were certainly not a dependable way to get there.

Bad Debt. Consequently, the investment-rating agency Moody's downgraded Thailand's short-term debt rating. Moody correctly

argued that this over-reliance on volatile, footloose money made Thailand increasingly vulnerable to a Mexican-style financial shock. The IMF told Bangkok much the same thing. Bangkok stubbornly ignored their warnings.

Over-capacity. Before long, the Thai economy became addicted to cheap foreign currency. The huge capital inflows left Thai banks awash in cash. Thai banks asked themselves, "What should be done with all this money?" Thai banks turned around and lent too much of this huge pool of excessive liquidity to politically well-connected businessmen for hare-brained schemes. A huge property glut developed, which in turn triggered more and more bad loans.

Financial Crisis Arrives

Pressure started to build on the Bank of Thailand in December 1996 to devalue the baht. Revelations that several of the Thai finance companies were over-exposed to the foreign financed property glut triggered a speculative attack on the baht in early February 1997. By March Bangkok was facing the most serious financial crisis in Thai history. But the truly remarkable aspect of the Thai crisis was the poor response of the Bank of Thailand (BOT). The outcome for Thailand would have been much improved if the bank had simply ignored the crisis and done nothing more than letting the baht float.

In the first two weeks of May 1997, the BOT decided to switch its intervention to defend the baht from spot foreign exchange transactions to forward transactions, buying baht against dollars for value in three months. The BOT chose to ignore the implications for its balance sheet. The BOT was therefore massively exposing itself to the fate of its own currency. Speculators thereby effectively received a subsidy from the bank to take short positions in the baht. Thanks to the BOT, the baht then turned into a one-way bet for short sellers. It would have been practically impossible for the short sellers to accumulate such an enormous short position in the baht had it not been for the sales that the BOT made.⁷

Similar to Mexico. The exact parallel here is with the blunder made by the Central Bank of

Mexico in issuing the dollar-linked tesobono bonds discussed earlier. Like the dollar-linked tesobonos, the Thai bank's forward contracts constituted a financial time bomb that the bank itself planted underneath the state treasury. Nothing can excuse the BOT having committed the financial blunder of the decade in supplying all comers with massively cheap financing on short baht positions.

Reserves Shrink. Despite optimism in Bangkok that things would get better, the economic data in no way supported such blind optimism. The grim facts included a slowdown in Thai exports and GDP growth, a sharp fall in the stock market and more and more bad loans.⁸ The data showed that unexpectedly high imports had caused the current account deficit to balloon. With a shortfall of capital inflows, Bangkok had to use \$4B of foreign reserves between the end of April and the end of May to cover a balance of payments deficit.

Baht Falls. On July 2, after spending billions of dollars trying in vain to maintain the baht at around Bt25 per dollar (where it had stood for more than a decade), Bangkok announced a managed float, thus abandoning the peg to the dollar. Unfortunately, Bangkok offered the markets no coherent economic strategy to accompany the so-called managed float. By early September, the baht went into a nose-dive, dropping to the Bt38 per dollar threshold for a fall of 32% against the dollar since July. In the next 6 months the baht dropped from 26 to the dollar to 55. Thailand circa 1997 indeed had turned into Mexico circa 1994. With no credible way to plug the hole in its balance of payments or to finance more rescue schemes, Bangkok was forced to look for outside assistance. In early August the Thai government accepted IMF conditions for a \$17.2B financial package.

Lessons Learned

In this chapter and the previous one, we've looked back at global financial turmoil in the 1990s. The findings from this study will hopefully provide insight for shaping key U.S. decisions on a number of global economic and financial issues. We've studied those events—in Europe, Latin America and Asia—

where the sharpest reversals of financial fortunes took place. So what have we learned?

Macroeconomic Mistakes. First, large-scale and ill-advised macroeconomic policies of the major economies can and do have major impacts on regional and global financial order. In Europe, we saw where German Chancellor Kohl's worry free view of German unity was dead wrong. Based on this faulty assessment, the Kohl government badly mismanaged German unity. Bonn made one bad economic decision after another.

- The first mistake was the virtual one to one conversion rate between the eastern mark and the western mark.
- The second mistake was rising wage parity between east and west German workers.

Together, these mistakes caused the costs of German unity to soar. Karl Otto Pohl, President of the Bundesbank, correctly predicted "disaster" and resigned as a statesman in protest over Bonn's follies. Instead of cutting spending or raising taxes, Bonn made a third mistake.

- Bonn over-borrowed to finance these soaring unity costs. In an over-zealous war against inflationary pressures, the Bundesbank counter-punched and raised interest rates, which in turn hammered the Italian and UK economies. What was missing in Germany was economic and financial leadership.

Fed's Monetary Overkill. We've also seen where over-zealous U.S. policy initiatives damaged the Mexican and Asian economies in the 1990s. For instance, the U.S. Federal Reserve raised interest rates seven times in a nine month period in 1994. While these actions did not cause the peso crisis in Mexico, the Fed's actions certainly worsened Mexico's financial problems. Had the Fed given more consideration to Mexico's dilemma, the peso crisis would arguably have still happened. But perhaps the huge bail-out of Mexico might have been smaller and the subsequent Mexican recession less severe

had Washington possessed more situational awareness of Mexico's financial mess.

Overly Strong Dollar Policy. Similarly, Washington orchestrated a strong dollar policy with the other G3 countries that was probably short-sighted, with little or no consideration given to how this action would damage the developing Asian economies. Again, the Asian economic crisis would arguably have still happened. But perhaps the huge bail-outs of Thailand, Indonesia and South Korea might have been smaller and their subsequent recession less severe if Washington had possessed more situational awareness of the Asian financial mess.

China's Devaluation. Finally, China's decision to devalue was also shortsighted and worsened the financial turmoil in the rest of developing Asia.

Not Helpless Victims. That said, we've seen that crisis-hit economies were in no way helpless victims of an unjust international financial system; nor is financial breakdown "a nomadic creature" with the power to settle into any address of its own choosing. On the contrary, the financial crises never arrived without having first received a "hand-delivered invitation" from domestic policymakers. The financial problems of the 1990s were not caused by any malfunction in the international financial system. Financial disaster was initially and primarily homegrown. In this sense, the free market too often gets a "bum rap" from the advocates of financial reform. In short, crisis-hit economies "largely shot themselves in the foot."

ERM Too Rigid. While ERM is not a pure fixed exchange rate regime, we learned that this so-called convergence half-way house is unstable. It was far too rigid to accommodate the conflicting pressure from a European recession that demanded low interest rates and a botched German economic and monetary unification that demanded high interest rates. We also saw the folly of the UK entry into ERM at a heavily overvalued exchange rate.

Overvalued Pound. In addition, we learned the futility of the UK trying to defend their

overvalued and exchange rates by exhausting billions of dollars of currency reserves. The UK attempt to raise interest rates to defend these absurd exchange rates was equally futile. George Soros and other currency traders realized that the UK simply could not sustain high interest rates in the face of politically unacceptable rising unemployment. The market is simply too powerful for governments to pursue ill-advised policies. It would have been far more sensible for the UK to float the pound before the crisis or at least in the early moments of the crisis. It was no coincidence that the UK economy did much better once it left the ERM and the Bank of England finally had the freedom to ease monetary policy without hysteria.

Common Denominators: Moreover, we learned that the common denominator in practically every financial crisis in the emerging market economies in the 1990s were:

- Fixed (or nearly fixed) exchange rate regimes and persistent and
- Large current account deficits.

Trade Imbalance. Mexico and Thailand were both running huge current account deficits of 8% of GDP. Their governments were not worried. Their central bank claimed they were "loaded" with foreign reserves to hold off an attack on their fixed exchange rates. Yet when the crisis struck, the size of their reserves proved woefully inadequate, something that could have been deduced from what had happened to the much larger European central banks in the ERM crises of 1992 and 1993. Making this situation worse was the Thai corporate practice of borrowing on a short-term basis.

Deadly Combination. We've also seen the implausibility of an emerging market nation's running a sustained, large current account deficit while trying to maintain a fixed exchange rate regime. The capital that flows in from abroad, which sustains the current account deficit, can stop or even reverse direction in an instant if there is even a whisper that devaluation is being considered. The most crisis-prone environment of all combines a fixed exchange rate system, a

history of current account deficits and an investment environment where confidence is rapidly decaying. That in fact was the combination of factors, the perfect witch's brew, that brought down Mexico and most of Southeast Asia.

False Indicator. In addition, the Mexican government argued that that the \$91B in capital inflow was more than enough to offset its financial liabilities. The government also argued that this capital inflow was a "vote of confidence" in the Mexican economy. We've learned that nothing could be further from the truth. The capital inflow in Mexico and Thailand resulted from a Thai baht and a Mexican peso that were drastically overvalued and required a huge interest rate differential from the U.S. dollar to fend off devaluation. These fixed exchange rate regimes incubated the buildup of massive foreign exchange via carry trades and huge foreign debt markets. Both were motivated by the illusion that fixed exchange rate regimes were permanent. While these regimes all promised currency stability, the day of reckoning for these financial pressure cookers ultimately arrived with a devastating explosion.

Conclusions

Based on these lessons learned, we can make a number of recommendations:

- Develop a global consensus that supports free international capital markets.
- In this regard, keep international capital markets free from moral hazard. Keep the connection between choices and outcomes. In short, don't eliminate risk assessment in investment decisions.
- Encourage almost all countries to choose a floating exchange rate regime. Floating exchange rate regimes will reduce the strain on foreign exchange reserves and the need for large IMF bail-outs.
- Discourage fixed exchange rate regimes for all but tiny economies.⁹
- Discourage most countries from running high current account deficits.
- Persuade large economies to give more consideration to what goes on outside their borders when they make critical

macroeconomic and international economic decisions.

- Strengthen IMF capacity for better and earlier situational awareness of financial turmoil.
- Persuade large economies to adopt more insightful macroeconomic policies that would also reduce the need and the size of bailouts.
- In short, an ounce of prevention is worth more than a pound of a cure.
- If countries insist on maintaining fixed exchange rates, then we need to prepare for the worst and hopefully avert it with good crisis management in the early stages of financial deterioration.

A Financial Early Warning System. In this regard, it's not enough to look back and determine what went wrong. It's also important to know what to watch for in the future to avoid other financial train wrecks. We need to closely monitor economies at risk and vulnerable to financial turmoil. Instead of passively waiting for the next financial crisis to occur and then suddenly reacting to it, we need to be more pro-active to early indications and warning (I&W) of financial turmoil. In other words, we need to make sure policymakers are not "caught off guard" by sudden financial turmoil. But how do we know which countries are at risk?

We need to develop an early warning system for national financial chaos. This financial indications and warning (I & W) system would sound alarm bells when a state's economic performance is in the danger zone. Some of the I & W alarm bells fall into the following five broad financial categories: an overvalued currency (fixed exchange rate system), inability or no political resolve to defend currency, the nature of high current account deficit (sustainability), the nature of capital inflow and the nature of the debt. In addressing each category, we have a number of specific factors we would watch. For instance, in analyzing whether a currency is overvalued, we will watch three indicators: inflation differentials (which carry traders exploit), an export slowdown and a current account deficit as a percent of GDP. In assessing a current account deficit, we might

use the following "ball park" signals. If a country has a current account deficit of say 3% of GDP, that's in the safety zone (green light). If a country has a current account deficit of 5% of GDP, that's a reason for concern (yellow light). If a country has a current account deficit of 8% of GDP (where both Mexico and Thailand were before their meltdowns), that's cause for alarm or a red light.

In addressing whether or not a country can defend its currency, we need to look at both the actual foreign reserve level as well as the more subjective call of whether the country has the political resolve to defend the exchange rate. A good example here would be China. China certainly has robust foreign reserves. But does China have the political resolve to defend its currency with such high levels of unemployment and social unrest? In this case, it's absolutely essential for the economists to check with political analysts before making the call. We also need to look at monetary policy constraints. For instance: Will an upcoming election kill the political will to raise interest rates to defend the currency? Will weak banks and/or a property bubble make it impossible to raise interest rates to defend the currency? For instance, the government might be fearful that the whole banking system would collapse under such a credit crunch.

We also need to look beyond the actual current account as a percentage of GDP. In asking whether or not a high current account deficit as a percentage of GDP is sustainable, we need to ask: Are the imports going mostly for investment (good) or for consumption (bad)? If the imports are mostly going for investment, then we need to ask: Is this investment going for tradable goods (exports)—which is good; or for non-tradable goods (e.g. over-saturated property market)—which is bad? If robust capital inflows (in the capital account of the balance of payments) are offsetting a high current deficit, we need to ask whether the capital flows are primarily stable (such as foreign direct investment)—which is good; or primarily unstable (stocks or hot money)—which is bad?

Finally, in assessing private foreign debt, we need to look at the following: How much debt is stable and of long-term maturity and how much is less stable and of short-term maturity? And what percentage of the debt is hedged (protected) in the futures market—which is good—and what is unhedged (vulnerable to currency devaluation)—which is bad? In short, U.S. and foreign government organizations need to share research and work closely with other international financial agencies to develop and take advantage of an early warning system that would give U.S. and foreign government officials a strategic warning of global financial turmoil.

Endnotes

- 1 World Bank, *The East Asian Miracle*, 1993.
- 2 I agree with the Wall Street traders who perceived the Asian currencies were overvalued. That's why they attacked them. On the other hand, some analysts take a more technical view and disagree with me and Wall Street traders that the Asian currencies were overvalued. For instance, Morris Goldstein argues that on most technical yardsticks such as estimates of purchasing-power parities (PPPS, which equate the prices of a basket of goods and services in different countries), most Asian currencies were actually undervalued.
- 3 The Philippines was the exception. After years being "lost in the wilderness" fighting the New People's Army (NPA), the Philippines finally got its economic house in order and emerged as a competitive low wage producer of low tech goods. It actually ran healthy surplus in its current account due to strong exports as well as capital inflows from overseas Filipinos. Its currency fell more because of regional contagion than because of flaws in its national economic strategy.
- 4 Ill-advised investment spending on unnecessary capacity is especially dangerous if it is coupled with rapid monetary growth, which tends to inflate an asset-price bubble. Of course, when the bubble ultimately burst, it left Thai banks with huge bad loans on their books. Like Mexico in 1994, Thailand had way too much money sloshing around in 1996 and 1997.
- 5 The Thai central bank pegged the baht to a basket of currencies in which an estimated 84% of its value was accounted for by U.S. dollars.
- 6 The trade frequently consisted of a long position in the Thai baht that was hedged with forward contracts in the basket currencies. When the baht floated, it plunged, and investors took the full hit for the devaluation and were left owing debts in hard currency.
- 7 DeRosa, David F., *In Defense of Free Capital Markets*, 2001.

- 8 By the end of June 1997, about 12% of bank loans and 20% of finance company loans were non-performing, worth in total about Bt1 trillion or 20 percent of GDP. By the end of May finance companies had liabilities of Bt 1.39 trillion, outstanding foreign loans worth Bt 111B and outstanding promissory notes worth Bt 912 B.
- 9 For those tiny economies that argue that floating exchange rates are "too volatile", remind them that the trendy currency boards or dollarization equate to sacrificing their monetary policies to say the U.S. Federal Reserve. That means if the economic problem is recession in the small economy and the economic problem in the United States is inflation, understand that the Fed may well inadvertently worsen unemployment in this small economy via higher interest rates.

CHAPTER 3

ASIA'S BOOM AND BUST

Introduction. Asia's economic roller coaster shows no signs of stopping. In the past five years, an Asian economic miracle has given way to:

- Economic crisis in 1997
- Recession in 1998
- Bounce-back in 1999/2000
- Downturn/Recession in 2001

Downward Drivers. The economic drivers that lifted these economies out of recession in 1999 are losing their punch. At a minimum, a variety of factors have slowed down growth in 2000. These negative factors include:

- Weaker U.S. economic growth
- As U.S. high tech demand falters, the U.S. economy slows down, which in turn reduces the U.S. appetite for Asian exports.
- Political instability in the region (scaring off investors)
- A spike up in oil prices

Financial Instability. In addition, the day of reckoning for incomplete corporate and financial reforms is here.

- Asian stock markets and foreign exchange rates have already plummeted.
- This slowdown could easily deteriorate into an even worse boom and bust scenario unless Asian leaders get more serious about reform.
- Asian states need to make their economies less vulnerable to evidence of rising financial turbulence in Asia and the rest of the world.

Key Questions: What other stresses could derail things? And what policy actions could minimize the risks and make these economies less vulnerable to financial turbulence?

Rising Deficit Spending. Before answering these questions, let's first ask, Which factors have been driving this bounce-back? And are these economic drivers sustainable?

- For starters, a Keynesian surge in government deficit spending helped to

drive domestic demand and lift the crisis-hit economies out of recession.

- Countries that consistently ran budget surpluses ran large budget deficits.
- For instance, among the nine major Asian developing economies, only Singapore is still running a budget surplus.

Emerging Problems. It's now clear that the recovery in 1999 had a strongly cyclical tinge to it.

- Non-sustainable economic drivers—such as deficit spending and buoyant demand in the United States for Asia's technology exports—drove Asian growth.
- While the Asian region is still recovering, progress on economic reforms has been spotty at best.
- Momentum is slowing down in corporate and banking restructuring.
- Institutional structures fully supportive of sustainable growth don't exist yet.
- While bankruptcy laws are now in place in many of the economies, enforcement is still a major issue.

Falling Foreign Direct Investment (FDI). These structural reform shortfalls continue to worry investors, who in turn are reducing FDI in many Asian economies.

- Investor exuberance about Asia as a whole has given way to a new realism.
- In particular, investors started making distinctions about Asian economic leaders and Asian economic laggards.

China Up, ASEAN Down. While it's always difficult to generalize, the laggards began to cluster inside ASEAN.

- This past year, ASEAN economies received just 17% of the FDI that flowed to developing countries in Asia, down from around 61% in the early 1990s.
- In contrast, China, which got just 18% of the FDI coming to developing Asian economies a decade ago, received 61%.
- In short, the tables have turned.
- ASEAN economies are starting to lose "head to head" competition with China to attract FDI.

ASEAN Protectionism. Why is this happening? At a time of when ASEAN should be making every effort to move toward trade liberalization, ASEAN states are moving toward more protectionism.

- At the ASEAN meeting in Chiang Mai in September 2000, ASEAN states agreed to allow countries to delay honoring their tariff reduction commitments.
- Malaysia is already going down this protectionist path.
- Malaysia announced earlier in 2000 that it would not meet its obligations to lower tariffs on automobiles imported from Southeast Asian countries
- Why? It's afraid that its national car, the Proton, would be unable to compete with a flood of imports.
- Potential investors fear that now Malaysia has set a precedent.
- Other ASEAN countries will request delays in lowering tariffs as well.

External Oil Shock. Another serious blow for many Asian economies was the surging price of oil, which hit a 10-year high of over \$34 a barrel early in the millennium (although it fell to \$18 during the 2001 recession and then rose to \$23 a barrel in February 2002).

- No other region of the world is as vulnerable to soaring oil prices as Asia.
- Why? Asia relies more heavily on energy-consuming manufacturing for its growth than the West.
- The energy price hike forced oil-consuming Asian states to boost energy spending at the expense of investment.
- The net effect is a long term-drag on Asian productivity.
- Oil spike up also eats away at consumer spending power.
- Depressed consumer spending could dampen corporate earnings.
- The worry is that falling corporate earnings could eventually take almost 2% off overall profit growth in 2001.

U.S. Slowdown. As external demand in the United States slows down, Asian companies that can now barely pay down their high debts are quickly going under.

- The electronics sector—a key economic driver in places like Taiwan—is a potential example of a mini-cycle downturn in growth.
- Computer chipmakers and other technology stocks have been battered in recent months over fears that the global electronics boom may be peaking.
- Besides fanning global financial turmoil, this trend is prompting Asian states to cut social spending, thus worsening the plight of Asia's poor.
- That worsens ethnic conflict, as it did in Indonesia after the outbreak of the Asian economic crisis.

Falling Asian Stocks. In addition, stock markets in much of Asia have been falling.

- Stock market declines have been especially pronounced in South Korea, Indonesia, Thailand, Taiwan and Japan.
- The worst hit stock markets, such as Thailand and the Philippines, have hit lows similar to those experienced during the worst phases of the Asian economic crisis.

What's wrong? Asia's dependence on high-tech is causing problems as high tech demand weakens around the world.

- Falling demand for dynamic random access memory (DRAM) chips have caused prices to plunge.
- This weak tech demand and troubled financial systems are the two key factors that have caused Asian stock markets to plunge in recent months.

Worsening Economic Crisis. The U.S. appetite for imports of Asian information technology (IT) goods has dried up.

- That equates to U.S. "exporting" recession to Asia.
- As unemployment rises in Asia, the worst is yet to come.
- The accelerating Asian recession will fan social unrest, political instability and quite possibly internal military conflict.
- USG must now use all the instruments of power in a seamless web to stem the tide and limit the damage to vital U.S. national interests.

Bounce-back. To better understand this worsening crisis, let's go back to 1999 & 2000. Back then, Asian economies performed remarkably well.

- The Asian economies that were crisis hit in 1997 and 1998 enjoyed an average GDP growth of almost 7%. South Korea averaged 10%.

U.S. Boom. Asia's spectacular rebound owed much to U.S. economic boom.

- Asian exports to U.S. account for 10 - 25% of Asian economies' GDPs.
- About one-half of these have been of IT equipment.
- U.S. corporations rushed out to buy this new IT hardware and Asia's factories were ready to surge to supply it.
- Asia was perfectly positioned to ride the IT tidal wave to recovery.
- Thus, America's economic boom in the late 1990s helped the crippled Asian tigers to recover more quickly than expected from their financial crises.¹
- At first glance, all was well during this bounce-back. After all, Asian exports were booming, which in turn produced large current account surpluses.

Asian Vulnerabilities. But Asia's large trade surpluses—popularly seen as a sign of renewed economic vigor—partly reflected a dangerous failure to generate stronger domestic demand.

- Domestic demand would have been stronger if Asian states had not become complacent and delayed the completion of their promised structural reforms.²

Addicted to Exports. Dithering on reforms has made Asian economies dangerously over dependent upon their exports to the U.S.

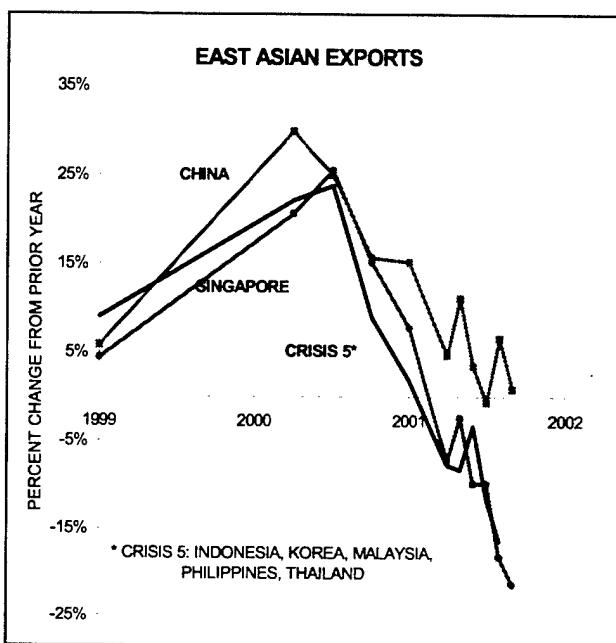
- South Korea's exports of goods and services jumped from 30% of GDP in 1996 to 45% last year;
- Thailand's rose from 39% to 66%.
- Electronic equipment now accounts for over half of total exports by Malaysia, Singapore and the Philippines.
- It makes up as much as 80% of Malaysia's exports to the U.S.

- Two-fifths of Asia's total GDP growth in 2000 came from exports of IT to America, according to Morgan Stanley analysts.
- Asia was thus more exposed to the U.S. and world slump than ever before.

U.S. IT Bust. The U.S. boom of 1999 and 2000 turned into an alarming bust.

- Between January 2000 and July 2001, the price of standard 64-megabyte DRAM chips dropped by 90% from \$8.93 to just \$0.92.
- As a result, U.S. firms cut their IT investment and, hence, their imports from Asia.

Figure 3-A



IT Cutbacks. The impact of the IT bust on East Asia's exports and economic growth has been catastrophic.

- In the countries that had invested most in electronics production (e.g., Malaysia, Singapore, Korea and Taiwan), exports contracted sharply in 2Q01.
- New orders for computers and electronic products fell by a one-third in the year to May 2001, as U.S. capital spending vanished.
- U.S. corporations have an alarming excess of technological capacity worth upwards of \$500B, according to some

Wall Street analysts. This overcapacity caused corporate spending to collapse.

Asian Economic Downturn. All of this is hammering the Asian economies.

- Exports from East Asia, excluding China, have fallen by 10% over the past year, compared with growth of almost 30% in early 2000.
- Real GDP fell in Singapore, Taiwan and Thailand in 1Q01.
- Singapore's economy contracted for the second quarter in succession, pushing the island into recession. And Singapore is the best house in a bad neighborhood.
- Taiwan's exports plunged by 16.6% in June.
- Malaysia's exports fell by 7%.
- South Korea and Hong Kong will be lucky to see GDP growth of 2-3% in 2001; down from rates of 9% and 10% respectively in early 2000.
- China's GDP growth is holding up, but even its export growth has slowed from almost 40% to 4% over the past year.
- Asia is also reeling from sliding currencies, weak stock markets and soaring corporate defaults.

Better Shape than 1997. At first glance, this all bears an eerie resemblance to the nightmare of 1997-98. Bad as things seem, this negative picture does not mean Asia is heading for another Asian financial crisis. In macroeconomic terms these economies are in much better shape than in 1997.³ All the crisis-hit economies of 1997 have:

- Built up robust current-account surpluses instead of deficits,
- Cut short-term foreign debt,
- Amply replenished foreign-exchange reserves.

Good News: Currency Flexibility. Except for China, Hong Kong, and Malaysia,⁴ these crisis-hit Asian economies of 1997 have:

- Abandoned their fixed exchange rate regimes that were at the root of their previous meltdown.⁵

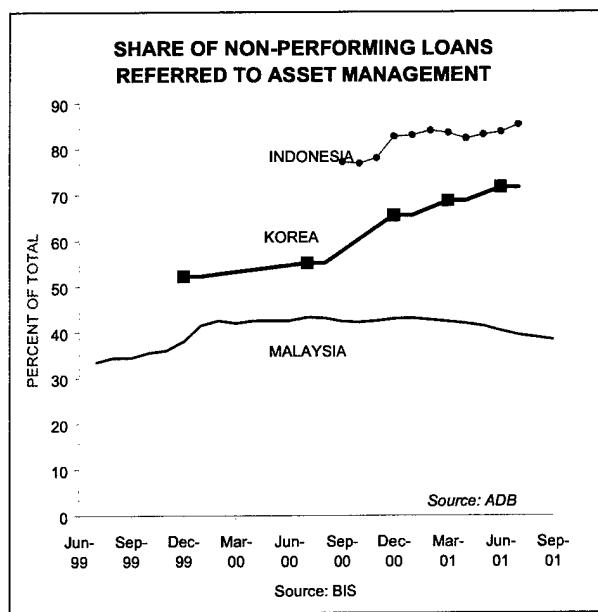
Bad News: Economic Stagnation. All this precludes the sort of overnight currency collapses seen in 1997.

- That said, the risk is that this economic downturn could be even more deep-seated and longer-lasting than the short-lived crunch of 1997 and 1998. Why?
- These economies have no economic driver to replace exports.
- In particular, domestic demand remains weak. Why?

Weak Domestic Demand. Domestic demand has been restrained by balance-sheet weaknesses in banks and companies.

- Firms have been slow to sell off assets and reduce debts.
- Banks have been slow to write off bad loans.
- The rate of referral of non-performing loans to asset management is slow. Malaysia shows absolutely no progress, while South Korea recognizes the problem and is gradually managing its losses.

Figure 3-B



- Governments have failed to deregulate services, which could have created new jobs to offset the collapse in IT exports.
- Fragile banking systems and inadequate corporate restructuring continue to cramp domestic expansion.

- Lower interest rates are less effective in stimulating demand because banks saddled with too many bad loans are reluctant to lend more and debt-laden firms cannot borrow.

Pushing Monetary String. These continuing structural flaws will now make it harder for Asian governments to use monetary policy to cushion their economies against a slump in exports. In particular, fragile financial sectors and companies' weak balance sheets will make monetary policy less effective (like pushing string). As Japan has discovered, lower interest rates can do little to boost domestic demand if:

- Banks, saddled with bad loans, remain reluctant to lend and
- Debt-laden firms remain reluctant to borrow.

Fiscal Constraints. Similarly, the crisis-hit Asian economies have little elbow room to use fiscal expansion to stimulate demand.

- A legacy of the 1997-98 crisis is that many countries already have swollen budget deficits.
- Asian economies, excluding China, ran an average budget deficit last year of almost 4% of GDP.⁶
- In 1997, before the full force of the financial crisis, their budgets were close to balance.
- Thus, Asian governments have less scope to use expansionary fiscal and monetary policies to boost flagging domestic demand.

Lost Opportunity. Asia's emerging economies would be better able to cope with a sharp slowdown in America if they had completed their structural reforms.

- The region's leaders may be wishing they had done more to build the foundations of stronger domestic demand during the years when the American economy was cruising and pulling the rest of the world along in its wake.
- In particular, they may rue the day that they became complacent and failed to undertake a more thorough restructuring

of indebted companies and of the banks that had lent them money.

- The necessary reforms always entailed painful short-term economic, social and political costs.
- But if they were difficult when the global economy was humming, they are very much more difficult now that it is wobbling.
- In short, Asian governments have failed to finish the repair job left from their previous crisis.

Outlook: Delayed Impact

Asian economies are still embattled.

- Asia's export figures lag U.S. electronics orders by around three months.
- In other words, the crushing 21% year-on-year fall in Singapore's electronics exports recorded in June 2001 reflects the 7% drop in U.S. orders in March.

3Q01 Blues. In 3Q01 Asia saw a terrible export shock, with a 30% to 40% year-on-year decline in exports.

- Singapore, where electronic products make up more than 50% of total exports, is already in recession.
- Taiwan, where the proportion is almost as great, looks set to follow.
- At best, U.S. demand for Asian electronics probably will probably not pick up anytime soon.

U.S. Rescue? With few policy options at their disposal, Asian governments are pinning their hopes on a recovery in U.S. corporate profits over the second half of the year and a rebound in investment spending early in 2002.

- The Federal Reserve's interest-rate cuts plus the \$40B tax rebate in 2001 add up to powerful medicine for the U.S. economy.
- The massive U.S. tax cut will also be expansionary.
- Asia's policymakers hope that this U.S. macroeconomic stimulus will trigger a U.S. recovery, which in turn will feed through to a boost in demand for Asian exports. Too bad things are not that simple.

No Bounce-back. Unfortunately, the world has changed since 1999. The U.S. economic

cavalry cannot show up and save the day. Even if the U.S. economy turns around and starts growing in the next few months, it does NOT follow that U.S. businesses will ride to Asia's rescue. Why not?

- When spending does finally recover, IT managers will be under pressure to show tangible return on their investments.
- This means they will focus first on software to reduce costs.
- Replacing the sort of hardware manufactured in Asian factories, which are heavily geared towards personal-computer production, will be a very low priority.
- In short, the PC is old technology and not where intelligent U.S. businessmen want to be focusing their investment energies.

Therefore, the immediate outlook for Asia is grim indeed.

- Countries in the region, Taiwan and Singapore especially, have over-invested in just one sector (electronics manufacturing), leaving them highly vulnerable to shifts in technology.
- And as the steep drop in capital-goods imports to the region over the first half of the year shows, there is little money around just now for re-engineering Asia's overexposed economies.

U.S. Recovery? The good news is that the U.S. and global economy appear to be bottoming out. A U.S. and global recovery is likely to take place later in the second half of 2002.

- The bad news is that weak U.S. corporate earnings and a collapse in U.S. capital spending has delayed the U.S. recovery.
- In this regard, the recent Enron debacle and the shoddy accounting at Arthur Andersen have worsened this situation by undermining confidence in the U.S. business culture.
- Finally, U.S. economic problems have also delayed a strong Asian recovery in 2002. And due to structural problems in Asia, the Asian recovery will likely be weaker than would otherwise be the case.

Conclusions

The economic bounce-back in Asia is over. Economic growth is slowing down. Asian economies are increasingly vulnerable to a number of shocks. These shocks include the slowdown in the U.S. economy, the softening of Asia's information technology market, and until recently, the spike up in the price of oil.

Key economic reforms are slowing or halting. Reforms are sluggish in such areas as restructuring heavily indebted companies, restoring badly damaged banking systems, improving corporate governance, and curbing corruption. Borrowers have taken advantage of inadequate procedures for bankruptcy and liquidation to withhold repayments in the hope of getting better deals from bankers.

In this regard, the Asian financial crisis is not over. Asia now faces a legacy of heavy debt, skittish investors and household insecurity. To reduce their vulnerability to financial turbulence, Asian economies must clean up banks, restructure domestic corporate debt and implement good bankruptcy laws.

Endnotes

- 1 The super-competitive currencies of crisis-hit Asian states after devaluation in 1997 and heavy deficit spending also drove the strong recoveries.
- 2 How incomplete structural reforms cramp domestic demand will be discussed later in this paper.
- 3 That said, in one respect, matters actually look much bleaker than they did in 1997. Then most of the region enjoyed relative political stability. Now, from Indonesia to the Philippines, it looks more explosive, with FDI also leaving SE Asia.
- 4 China, Hong Kong and Malaysia are still pegged (*de facto*) to the U.S. dollar. Of these, Malaysia gives the most immediate cause for a devaluation concern, though China has said that the weak yen threatens its own currency and is hurting Chinese exports.
- 5 For an analysis of the dangers of pressure cooker, rigid exchange rate regimes in Europe, Latin America and Asia in the 1990s, see Leif Rosenberger, "Global Financial Turmoil: Diagnosis and Prescription for President Bush," in the forthcoming book entitled *The Search for United States Security: A Forward Strategy for the 21st Century*, to be published by the Army War College Strategic Studies Institute.
- 6 As part of the Maastricht rules of thumb for financial stability, budget deficits should remain under 3% of GDP.

CHAPTER 4

ECONOMIC STRATEGY

IN THE WAR ON TERRORISM:

Dr. Leif Rosenberger, USCINCPAC and
Dr. Clay Chun, U.S. Army War College¹

Introduction. On September 11, 2001 the United States faced a national security disaster. The attacks on New York City and the Pentagon snapped the nation into immediate action:

- Military forces were mobilized,
- President George W. Bush created an Office of Homeland Security, and
- Congress passed several pieces of legislation that were directly related to a global war on terrorism.

Economic Response. A crucial element of the federal government's action was the immediate call for economic assistance to local municipalities, businesses, national, and international actors.

- The economic assistance arising from the 9-11 attacks and subsequent military and political actions provide an interesting case for the study of the economic instrument of power.
- This paper traces the immediate actions that were taken by national leaders in an attempt to head off financial disaster in light of the 9-11 attacks and the subsequent call for a war against terrorism.

Economic Instruments of Power. The U.S. government (USG) can call on several instruments of power to ensure a particular national interest is achieved or a specific objective met.

- The military instrument of power is addressed in other publications.
- The dissemination of information serves as a key instrument for mobilizing resources in an open society. Watching CNN or reading newspapers helps to activate individuals and organizations alike.
- This paper discusses the economic instrument of power in response to 9-11.

Why Strategy is Difficult. In formulating a successful strategy to win the war on terrorism, We must carefully consider the right mix of

military, political, informational, and economic instruments of power. Unfortunately, this is no easy task. Colin Gray—in explaining why strategy is difficult—frequently says that to tackle the fog and friction of war is akin to exploring unknown terrain.²

Similarly, Clausewitz argues that the key judgment that a statesman and commander must make is the kind of war he is fighting, not mistaking it for something alien to its nature.³ President Bush is well aware of this Clausewitzian challenge in addressing the war on terrorism. President Bush says,

"It's a different type of battle. It's a different type of battlefield. It's a different type of war and that, in itself, is going to be a real challenge for America."

In short, making the strategic call in war is no easy task. Making that call is equally difficult when applying the economic instrument of power in this new war on terrorism.

- Forecasting economic effects, taking the appropriate measures, considering the right timing, and measuring the impact of economic actions are very difficult.
- Additionally, since economic actions do not occur in a vacuum, the sensitivity to international events on domestic financial and economic activities has grown greatly.
- The dynamic conditions that affect the economy are difficult to predict, let alone control.

Three Economic Issues. Since 9-11, the United States is facing economic issues on at least three fronts:

- Reconstruction. First, the most visible need for immediate economic aid is to help New York City. Requirements to expand homeland security measures from state and local governments also drive additional support requests throughout the nation.
- Fighting Recession. Second, national economic concerns are also being addressed to mitigate a general economic slowdown that had begun before 9-11, but has accelerated since the terrorist strikes. Airlines and insurance companies have requested loan guarantees or grants to avert possible bankruptcy. Similarly,

consumer and business confidence fell, which fanned recession.

- Economic Diplomacy. Third, the United States is taking international actions to:
 - a) Help the United States and our allies and friends, and
 - b) To immediately attack terrorist foes.

Washington had to calm world markets and ensure the free flow of international trade and finance. The U.S. reliance on coalition members and non-state actors to support a global assault on terrorism also required resources.

- The United States blocked terrorist assets and withheld economic resources against countries that harbored terrorists.
- U.S. foreign aid helps strengthen friends in the war against terrorism.

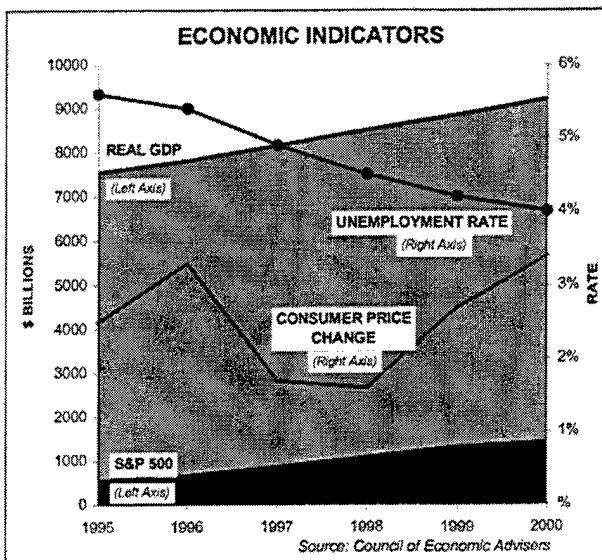
Context: Economic Slowdown

U.S. Economic Boom. Over the past year, the U.S. economy has been in the midst of transition from record high levels of economic activity to the current recession.

- From the mid-1990s to early 2000, the U.S. economy made tremendous gains. Gross domestic product (GDP), unemployment, inflation, and stock market performance indicated that the American economy was on the upswing. (See Figure 4-A.)
- The nation's GDP was experiencing real growth at a very healthy rate as high technology industries related to information technologies and bio-technology firms led the charge.
- Increased productivity among workers, partly caused by increased automation and information access, boosted GDP, as businesses were able to produce more goods and services for both domestic and international markets. Potential rates of economic growth were buoyed with increased productivity among American workers and businesses.
- This growth was manifested by very low unemployment rates through 2000.
- Individuals who invested in the stock market could not help but to increase the value of their portfolios. The S&P 500

Index almost tripled in value within this period.

Figure 4-A Economic Indicators



U.S. Economic Slowdown. By August 2001, the economy was still strong, but was showing signs of fatigue and stress.

- By the second quarter of 2001 real GDP had grown by a minuscule 0.3% compared to a similar period in 2000 at 1.3%.
- The unemployment rates rose to 4.9%. About 6.9M Americans were without jobs, in comparison to 5.5M a year before.
- Consumer prices were also rising to 3.7%.
- Firms that had increased their high tech investments by 20% per year from 1996 to 2000 began to cut back on such purchases at the point where they saw only marginal gains in productivity.⁴
- As businesses started to reduce their investment in high tech and information systems, firms that sold computer, communications, and information goods and services faced fewer opportunities and "downsized" their operations.
- Many supporting industrial sectors and services also fell like dominoes as firms pulled the plug on the information industry.
- Foreign suppliers also suffered and their earnings fell—which in turn reduced their ability to import American goods.
- Additionally, energy prices for oil, natural gas, and electricity were increasing by late

2000—thereby weakening businesses' financial position.

- State and local governments (notably California) were forced to subsidize utilities and support higher unemployment claims. They watched helplessly as budget surpluses melted into pools of red ink.

Stocks Fall. Stock markets were another victim of the economy's cooling.

- The S&P 500 Index dropped to 1,092.54 at the close of business on September 10, 2001 from its 2000 year-end closing of 1,427.22 points.
- The reduction in stock prices—due to reduced profits of high tech and other firms—caused the cost of capital to rise.
- Firms faced with decreased profits were forced to pay more for loans and to cut unprofitable operations, resulting in further unemployment.
- Consumers—seeing their wealth reduced—delayed or cancelled spending on items ranging from luxury items to ordinary goods and services.

Budget Woes. The federal, state, and local governments were not immune to the economic decline either.

- Decreased economic activity translated into reduced tax revenue and calls for increased, unexpected unemployment and social assistance to laid-off workers.
- The federal government's projections of a growing budget surplus vanished and deficit reduction efforts were delayed. The government could try to raise taxes, further reduce spending, or borrow funds—alternatives that all had serious economic consequences.

Slowdown. The economic downturn was not an American phenomenon either.

- The U.S. economy that was fueled by the globalization of free market ideas and access was now reeling as many nations' economies contracted.
- As the U.S. economy faltered, American consumers reduced purchases of foreign goods and services.

- Already shaken, Asian and European economies decelerated more rapidly.

General Response. In response to faltering GDP, the USG has a number of ways to boost aggregate demand.

- To close the aggregate demand shortfall, more spending must take somewhere.
- The USG can make it easier for consumers and businesses to spend money. This is done via tax cuts or cuts in interest rates.
- But if consumers and businesses lose the confidence or ability to spend money, the USG must have the confidence to spend enough money to close the shortfall of aggregate demand.

Fiscal Response. In response to the faltering economy, President Bush attempted several measures to alleviate the problem.

- Bush introduced measures to immediately increase consumer spending by reducing income tax rates in several areas and introducing tax rebates that were sent to households in the summer of 2001.
- Since consumption represents about two thirds of the nation's GDP, getting people to purchase goods and services in light of decreased economic activity was paramount.
- Higher demand for goods and services would maintain or even increase production, reduce unemployment, and steady the nation.

Economists debated the costs and benefits to society of cutting taxes and issuing rebate checks instead of reducing the surplus despite the worsening economy.

- The Bush administration's answer was not to increase overall federal government spending, but to focus on business and markets to create solutions.

Monetary Response. Similarly, the Federal Reserve System (Fed), tried to stem the tide:

- The Fed started to reduce the federal funds rate (the interest rate that commercial banks lend to one another overnight) in order to increase the amount of money in the economy.

The Fed's hope was to encourage investment by businesses and avoid a recession. These economic problems seemed to persist as the stock markets slid further and consumer confidence waned. Greenspan had increased interest rates just a year before to stave off a potential rise in inflation.

- Some critics have argued that the Fed's rise in interest rates contributed to the reduction in business investment that resulted in the slowdown in 2001.
- Conversely, some observers noted that the Federal Reserve System's continued rate reductions were having little immediate relief for the economic future.

In any event, the Fed engineered a program to cut the federal funds rate in half.

- For example, the federal discount rate (the rate that the federal government charges to banks) dropped from 6.0% to 3.0% from September 2000 to 2001.
- Commercial banks followed suit during the same period by reducing the prime rate (interest rates charged by banks to their best customers) from a high of 9.5% to about 6.5%.

Response Frustration. Unfortunately, nothing seemed to work. The economy was in decline, not simply experiencing temporarily weak or below average returns. The economy was sliding towards a recession.

- Investment was not rising.
- Manufacturers continued to lay-off workers and employment opportunities decreased.
- Income, sales, and production declined.

Crisis Strikes

Impact of 9-11. On September 11, 2001 two airliners struck and destroyed the World Trade Center Twin Towers in lower Manhattan that immediately disrupted the U.S. economy. Although another plane hit the Pentagon with a tremendous loss of life, it did not have the same economic impact of the New York attack. The combined attacks caused over 3,000 deaths and devastated the nation.

Striking the financial center of the United States and the world dealt a severe blow to a struggling U.S. economy.

- 9-11 hit world financial markets, investment banking, direct corporate operations, and equity and debt markets.
- It shattered the confidence of business and consumer alike.

NYC Reconstruction. In addition, New York City had to address the staggering costs of replacing the destroyed infrastructure.⁵

- On October 4, 2001 New York City Comptroller Alan G. Hevesi estimated that the city had suffered about \$34B in property damage.
- Other estimates for the national attack skyrocketed to \$75B. The city alone lost 13M square feet of office space—equal to the commercial office space of Atlanta.
- If one considers damaged areas too, more than 30M square feet of office space was affected.

Although one cannot replace the value of human life, the attacked resulted in a loss of "human capital" of \$11B from the productive capacity of the lost lives.

- For example, New York employs a significant portion of the nation's security investment, advertising, and book publishing workforce.
- Before the attacks, the financial services industry employed well over 522,000 workers, making it the biggest industry within New York City.
- About \$207.5B of an annual city income of \$444.4B was related to this sector.
- Tourism, another New York staple, was another casualty as people stayed away from the city.

Wall Street Woes. Fixing New York's problems, however, was not the only concern that national leaders considered while economic paralysis spread across America.

- Not only did consumer confidence sink, but also the New York Stock Exchange and other exchanges were closed for six days. The halted trading in securities added to heightened anxiety.
- Many of the firms located in the World Trade Center Twin Towers were directly involved in securities trading, but amazingly

the stock exchanges did operate, despite a fall of 7% in value on the opening day of trading.⁶

- Similarly, the disruption of airline services due to the fear of further attacks, increased security, public fear, and lawsuits that could drag many firms into bankruptcy.
- Additionally, major insurers could make the World Trade Center attack the most costly in history—threatening the financial viability of many insurers. Insurers would also need to raise more reserves and could do so by raising premiums—complicating industries that were already struggling to cut costs and boost profits.

American and foreign investors did not know the extent of the damages to the various stock, bond, and commodity exchanges in New York City. Access to communications, data, records, and securities traders were questionable after the destruction of the World Trade Center Twin Towers. Additionally, other buildings were damaged and many persons and businesses involved in the investment markets were without offices. Fear from further attacks in the lower Manhattan area also closed off many areas in the city. Fortunately, these concerns ebbed as solutions were found to operate the stock and other markets, albeit a few days later.

Airline Angst. Several airlines were already facing financial ruin before 9-11.

- Although United and American Airlines had both lost two aircraft each during the attack, the entire airline industry sputtered.
- The industry suffered from declining bookings of business travel, because of the general downturn in the economy throughout the summer.
- Additionally, increased labor and fuel costs had reduced further profits. Industry analysts had estimated that the airlines would lose \$3.5B in 2001 before the attacks, with United Airlines losing \$1B alone.⁷
- Airlines would have to brace for a host of new federal security measures, loss in passenger confidence, and lawsuits filed in conjunction with the attacks.

- Major carriers reduced the number of scheduled flights by 20% and saw flights filled at less than 50% on most routes one week after the airlines were permitted to restore services.
- Airlines close to the brink of financial ruin could declare bankruptcy and spark turmoil in the transportation industry.
- By September 17, the airline industry and Boeing, the sole United States manufacturer of major airline aircraft, had laid off 70,000 employees.
- Additionally, reduced airline services also affected tourism throughout the United States, shocking California and Hawaii, who, despite being a continent away from the East Coast, suffered large losses of tourism.

Insurers Hit. 9-11 also hammered the insurance industry.

- Insurers at and near the World Trade Center faced a host of claims from individuals, businesses, and building owners in terms of property and casualty, health care costs, worker's compensation, lawsuits against the airlines, and the prospects of rising premiums that might force the insured to find new alternatives.
- Insurance companies also face a problem with policies that protect firms from the interruption of normal activities. (Most firms purchase a policy that covers an interruption of normal business because of a catastrophe.)
- Thousands of businesses around the nation were affected from firms that were unable to communicate with New York offices or with those who trade on the stock market or sell commodities.

These claims will force insurance companies to raise premiums that will be born on the shoulders of business and individuals.

- For example, insurers started to increase a host of premiums on a variety of policies since the record payments made to the victims of Hurricane Andrew in 1992—when the industry paid out claims of about \$16B.

- Insurance premiums for the Miami area and Florida were boosted 250% and 110% respectively.

In light of these record payments, insurers started to diversify risk by using reinsurers.

- Reinsurers, who take a portion of the insurance liability from a policy writer, may default because of the magnitude of the attack.
- Major insurance firms that relied on these reinsurers may need to pay off claim amounts that were unanticipated.
- Many small insurers or firms that were involved in commercial property insurance face financial disaster given the virtual size of potential claims from New York, the other airline crashes, and other affects.

Shock to Aggregate Demand. The United States also faced a macroeconomic problem due to the terrorist-induced crisis. In essence, the U.S. economy faced a shortage of aggregate demand.

- Demand declined not only from the multiplier effects as supporting industries lost opportunities across the economy, but also
- There was a decline in demand due to a general malaise of consumer and business confidence in the face of such inhumane barbarism and attacks on basic freedoms.

Crisis Response

Policy Questions. Thus, a number of microeconomic and macroeconomic policy challenges confronted the government while also facing an immediate crisis. What steps should the government take? Clearly, the government would want to get the American economy back into operation. However, many policy questions remained unanswered.

- Should the government purposely support or subsidize industries that were damaged by the attack?
 - By their nature, insurance companies assume risk for disaster at a price that often excludes government subsidies.
- If the government declared the attacks as "an act of war," then would those firms be relieved of any legal liability?

- Does the government set a precedent by supporting industries whenever there are catastrophic events?
- Or should it limit its economic actions towards improving the general economy and letting the free market decide who survives?
- How should the government become involved in the running of the economy?
- What actions can and should the government take against any attackers?

USG Response. The United States economy seemed paralyzed after the attack.

- Uncertainty, fear, lack of communications, and other concerns slowed business activities in New York and around the country.
- Airline flights were grounded, stock trading halted, financial transactions delayed, and the federal government re-focused on the immediate attack.

In response, the USG took three major actions.

- First, the federal government moved quickly towards fiscal policy to provide funding for programs ranging from humanitarian aid to increased military spending.
- Second, monetary policy was used to increase the money supply to assure that financial institutions, businesses, and individuals could conduct transactions.
- Third, the government took actions in the international arena to support a coalition against terrorism and reduce the ability of certain actors to use financial resources.

These elements of economic power were tools that the government could use to achieve certain national interests: maintaining economic viability and national security.

Fiscal Policy

Funding Issues. The United States government faced several diverse economic issues in the wake of the 9-11 attacks.

- Calls for immediate homeland security and military action require additional funding for equipment, personnel, and operations.

- Not only were immediate actions required to secure airports and New York City, but preparing military personnel and equipment to deploy to particular theaters for an indefinite time period requires sustained budget increases.
- Since operations against terrorist organizations might involve Middle Eastern access to oil, some advocates of the domestic energy industry wanted government support to expand energy sources for the country.

Key Questions: These actions require national leadership to decide:

- How much to spend,
- How long it should last,
- Who gets funding, and
- How the nation will pay for these actions.

Key Funding Options. The government has several possibilities to fund programs:

- Raise taxes, borrow funds, change funding priorities,
- Divert surplus funds,
- Shift responsibilities for programs from the federal government to other actors.
- Additionally, the government could try to establish a proper environment to rebuild the economy.

Financing Options. The federal government can finance additional expenditures through increased taxes, reprogrammed activities, payments from a budget surplus, or via borrowing actions. But given the grim economic conditions in the U.S. and global economy, some of these options were non-starters.

- For instance, raising taxes would only reduce aggregate demand, worsen the recession, and fan rising unemployment.
- Additionally, Bush and the Congress had already passed a tax reduction program that summer. Likewise, existing programs were not touched.
- The government has fewer discretionary programs to reduce. The one major program left was defense, which would have to be increased to fight terrorism and secure the nation.

- The only other source was the surplus for the fiscal year. Instead of retiring the federal debt earlier, the government would continue to pay interest on the debt by using the surplus.
- Unfortunately, tax revenues that made the surplus possible would probably decline because of the economic slowdown in individual and business income and declining import tariffs—a double hit.

Tax Cut Program. Before the New York and Pentagon attacks, the Congress approved and President Bush signed a \$1.35 trillion tax reduction program into law in June 2001. But many legislators were leery about the cuts. Why?

- One of the concerns about such a hefty tax cut involved its impact on the budget surplus. In 2000, the federal government was straddled with a \$5.6 trillion debt.

Although the federal government had surplus budgets since 1998, the source of the surplus was excess Social Security and other retirement program tax receipts. (In 2000 the excess was about \$253.5B.)

- Many Democratic members of Congress were concerned that these tax cuts would be financed by the Social Security surplus alone.

The Bush administration and Congress made an agreement to use the Social Security surplus to only pay-off the debt by putting the funds in a “lockbox.”

- This lockbox was a restraint for policymakers to limit tax or spending initiatives to combat the sliding economy.

Supplementary Spending Items. Right after the attacks, President Bush requested emergency spending authority and appropriations for disaster relief, military operations, and to fight the war on terrorism.

- The House of Representatives and the Senate unanimously approved a \$40B supplemental spending bill on September 14.
- The Social Security lock-box was broken. Bush released \$5.1B on September 21.

- Approximately \$2.5B went to the Department of Defense to upgrade intelligence and security, readiness, force protection, and repair the Pentagon.
- Another \$2B was allocated to the Federal Emergency Management Agency for debris removal, individual and family assistance, disaster aid, and other support in New York and other affected areas.⁸

President Bush received discretionary authority to spend \$20B for post 9-11 programs.

- Congress then appropriated an additional \$15B to support the airlines. The \$15B funding for the airlines included \$5B in cash and \$10B in loan guarantees. The airlines had asked for \$24B.
- President Bush also requested \$18.4B for more defense spending and \$8.3 for ballistic missile defense programs from the Congress.

Ramping Up Government Spending. Some of the increased government spending will be temporary, but other amounts may create a larger, more permanent addition to the government. For example:

- Proposals to make airport security personnel federal employees would certainly add to the federal government bureaucracy.
- Other “automatic stabilizers,” e.g., welfare and food stamp programs, would also rise due to additional lay-offs during a slowing economy. For example, a part of the government’s fiscal stimulus also included an enhanced unemployment insurance program that extended coverage for unemployed workers from 26-weeks to 39-weeks.

Fiscal Stimulus. In response to clear signs that 9-11 was accelerating the plunge of the U.S. economy into a recession, additional calls were made for a greater economic stimulus program.

- In early October, President Bush requested an additional fiscal stimulus of \$60B-\$75B.
- The Senate Majority Leader Tom Daschle proposed one of \$50B.

Depending on which version one examines, the emphasis to improve the economy has wide-ranging policy implications.

- President Bush’s proposal included capital-gains tax cuts and increased depreciation write-offs on capital equipment.
- Democrats wanted a rise in the minimum wage.

These proposals were debated well before the 9-11 attacks by each respective camp. Some critics questioned whether each party was using the current economic downturn and emotions of the 9-11 events to pass long-held party positions and economic objectives.

Monetary Policy

Looser Monetary Policy. Monetary policy was another tool available to the federal government to alter economic conditions. The Fed went into action immediately after the attacks. He realized that worldwide financial uncertainty about the economic future could cause a global retreat on a number of economic fronts: banking, consumer, investment, and business confidence might plunge and worsen the damage to the United States’ economy.

- The Fed immediately ordered the purchase of federal government bonds that pushed excess money into the hands of securities traders and investors.
- On September 14, the Fed bought \$80B worth of U.S. Treasury securities on the open market and a further \$57B on September 17.
- The Fed also made an additional \$11.7B available for loans to banks.
- In addition, the Fed made an arrangement with the European Central Bank (along with separate arrangements with other foreign banks) to ensure that it would guarantee up to \$50B in currency exchanges to support foreign bank operations in the United States. Interest rates dropped fast.

The Fed was trying to boost consumer confidence and make sure that money was available for financial transactions to stabilize economic activities. The Fed also started to lower the discount rate and the federal funds rate. These sensitive rates were immediate

signals that the government would take action to stem the economic downturn.

- The federal funds rate had stood at 3.5% on September 10 and dropped as low as 1.25% on the September 18.⁹
- By late October, the rate stabilized to around 2.5%. The discount rate dropped from 3.0% on September 10 to 2.0% on October 26.
- These low interest rates, if one calculated the effective inflation rate, made the cost of borrowing almost negligible.
- Longer-term interest rates also fell, but not as dramatically.

Admittedly, encouraging business and individual borrowing is a long term process, but calming markets and consumers confidence is an important objective for the FED.

- Lower interest rates may have an effect on consumer behavior by reducing savings.
- As interest rates fall, returns on interest bearing securities such as passbook savings accounts or certificates of deposit have less appeal to individuals. They can invest in stocks, real estate, or other instruments for higher returns.
- Conversely, they may feel like they might as well purchase goods and services since savings provide lower future returns.

Natural Disaster Parallel. Except for the increased military and security spending, the U.S. response to the destruction of the World Trade Center Twin Towers and the Pentagon were generally treated as if the events were like a natural disaster.

- Earthquakes or floods can damage or destroy whole cities or regions.
- Fiscal stimulus can provide instant financial support for those communities.
- Monetary policy is usually used for national level economic concerns.

The difference between the 9-11 attacks and a natural disaster was the scope of the attack and the threat to the nation.

- The New York and Washington attacks had far reaching domestic and international impacts.

- National leadership was needed to wield the economic instrument of power to avert a further worldwide economic downturn.
- Additionally, steps were taken to reduce the apparent terrorist threat on an international level.

International Policy

Economic Sanctions. A common economic tool used against a nation-state or non-state actor is sanctions. Sanctions attempt to curtail or limit access or the benefit of trade or financial resources. Cutting off financial assets to 27 terrorist groups was a first step to limit or make support difficult for a terrorist network with no visible means of support.

Money and financial support is vital for terrorist groups.

- Financial resources allow terrorists to purchase equipment, travel, and live in targeted nations.
- Secretary of State Colin Powell observed that "money is the oxygen of terrorism."¹⁰

President Bush instituted sanctions against Usama bin Laden, the *al Qaeda* terrorist group, and other groups through Executive Order 13224, "Blocking Property and Prohibiting Transactions With Persons Who Commit, or Support Terrorism" on September 24.¹¹

- No United States citizen or person residing in the United States could make or receive any contribution of funds, goods, or services to or for the benefit of selected groups identified by the State and Treasury Departments.
- Additionally, no one in the United States could sell items to these groups or make donations.
- The Treasury Department was also allowed to take other actions such as disrupt the financial infrastructure of groups by freezing and blocking the use of assets held in the United States and coordinate actions with other countries to freeze or seize terrorist assets.

The Treasury Department created an interagency organization, the Foreign Terrorist Asset Tracking Center (FTATC), to observe

and identify the source and uses of financial resources of terrorist groups.

- As of December 2001, treasury has blocked almost \$70M in terrorist assets.¹²

No Easy Task. The large volume of typical banking transactions makes tracking and seizing terrorist funds difficult and expensive.

- The United States government must not only coordinate actions between law enforcement, federal banking regulators, the banking industry, and financial institutions.
- It must monitor international transactions.
- International banks and foreign governments have sought more evidence to seize financial assets.
- Additionally, ordinary citizens may question their invasion of privacy and banks may have to institute higher cost banking enforcement practices that will be paid by consumers and the banking industry.

UN Action. The United States had no need to take additional economic actions against the Taliban government in Afghanistan. In December 2000, the United Nations had passed Security Council Resolution 1333 that specifically targeted the Taliban since it harbored Usama bin Laden. United Nation members were directed to:

- Freeze bin Laden's financial assets,
- Institute an arms embargo against the Taliban, and reduce their offices and missions presence overseas,
- Ban the export of equipment to make heroin, and
- Close all non-humanitarian assistance flights into and out of Afghanistan.¹³

These sanctions were not a total stoppage of goods and services to the Taliban. Private sector trade and commerce, humanitarian aid, and exemptions to avoid hurting the Afghan people were allowed.

Support to Pakistan. President Bush supported the lifting of sanctions placed on Pakistan when its government supported United States efforts to capture bin Laden and conduct military operations in Afghanistan.

Sanctions were placed on Pakistan because it had detonated nuclear devices in 1998.

- The House of Representatives approved a two-year suspension on restrictions to economic aid for Pakistan in response to its efforts to help the United States.
- Along with lifting sanctions, the United States moved towards rescheduling up to \$379M in government-to-government debt.
- Additionally, the United States urged the International Monetary Fund and the World Bank to provide loans and aid to Pakistan.
- These actions rewarded Pakistan's government for support of American and allied nations against terrorism and domestic opposition.

Closer Ties to Jordan. Pakistan was not the only country that was given economic support. The United States also garnered support from another Muslim country against the war on terrorism, Jordan.

- President Bush and the Congress agreed to a U.S.-Jordan Free Trade Agreement that would create investment opportunities for that region.
- This trade agreement was designed to "send a strong message to Jordan, as well as other countries in the region, that support for peace and economic reform yields concrete benefits."¹⁴
- Bush signed the agreement on September 28.
- Although there was no financial direct aid involved, the trade agreement was a clear signal that the United States intended to strengthen economic ties with Jordan.

More Foreign Assistance. The United States also used foreign assistance to support persons and states in economic need.

- U.S. humanitarian assistance to Afghanistan totaled \$320M, while financial assistance was given to other countries, like Pakistan, to support Afghan refugees.
- The United States Government could also remove restrictions on and approve economic aid to nations that support American foreign policy initiatives.
- For example, on October 16, Secretary of State Colin Powell recommended to the

Senate Foreign Relations Committee that restrictions on financial aid on Azerbaijan be lifted.¹⁵

Conclusions

Economic Crisis Management. The United States had several tools available to contain a possible economic disaster and support a subsequent war on terrorism.

- Many of these tools were quickly used to stem a potential economic disaster in the United States and around the world.
- Additionally, some tools were used to support actions taken against terrorists and to complement military and political instruments in play.
- The economic instrument of power was able to take immediate action like freezing terrorist assets once they were identified or paying for additional security.

Longer Term Strategy. Other tools, however, are more long-term and complex. For instance:

- Stopping growing unemployment or slipping GDP growth for the world's largest economy in the world is no small order.
- For example, getting businesses to gather enough confidence to purchase new plant and equipment takes time.
- The government can provide some stimulus, but much of a country's economic growth needs to come from business and individuals.
- Fiscal and monetary policies help shape, but do not guarantee economic health.

Decisive Actions. Globalization has made economics a more valuable tool of influence around the world. The United States can and does take advantage of globalization by using its economic instrument of power as a flexible and powerful tool in achieving its goals in the war on terrorism.

- The application of economic instruments of power, in the case of the 9-11 attacks, was timely and aggressive.
- Actions were swift, decisive, and aimed at alleviating suffering, enabling operations, making structural changes, and soothing

the psyche of domestic and international actors.

New Ties That Bind. Nations that did not have much in common in the past now have shared instruments with trade and economic growth.

- Financial markets and national economies are more integrated and sensitive about any action that can affect trade or finance.
- Stock markets around the world trade securities of foreign firms as commonly as their own domestic firms.
- Equity investments, trade ministers, and world business leaders have much at stake with their financial transactions at home and abroad.
- They are heavily affected by actions within the United States.

New U.S. Resolve. President Bush has expressed a new U.S. resolve to win the war on terrorism. "We will not tire. We will not falter. We will not fail." In addition to winning the war on terrorism, President Bush is determined to return the nation towards the path of economic recovery.

Endnotes

- 1 This chapter is adapted from a paper by Dr. Clay Chun, Professor of Economics at the U.S. Army War College and a member of CINCPAC's Economic Security Working Group.
- 2 Colin Gray, "Why Strategy is Difficult," *Joint Forces Quarterly*, Summer 1999.
- 3 Carl von Clausewitz, *On War*.
- 4 Robert T. Parry, *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, July 6, 2001.
- 5 Peter Coy, *The Center Must Hold* *Business Week*, October 22, 2001; Aravind Adiga, et al "Sudden Impact," *Money*, November 2001; Lewis Braham, "On the Disabled List: New York" *BusinessWeek*, September 24, 2001.
- 6 "How Big A Blow?" *Economist*, September 22, 2001.
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- 8 White House Press Release, September 21, 2001.
- 9 Federal Reserve, *Statistical Releases H.15 (519)*.
- 10 State Department Press Release, November 7, 2001.
- 11 White House, *Executive Order on Terrorist Financing*, September 24, 2001.
- 12 Discussions with U.S. Treasury officials, December 2001.
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SECTION II

ASIAN ECONOMIES

CHAPTER 5 AUSTRALIA

Introduction. The worst appears to be over for the Australian economy. The bad news is giving way to good news.

- After negative economic indicators in 4Q00 and 1Q01, economic indicators turned positive in the summer of 2001.

Economic Bad News

Let's turn first to the bad news starting back in late 2000/early 2001.

Contraction. This past decade Aussie annual economic growth rate averaged more than 4% for nine years in a row—a better record than even the United States.

- But in 4Q00, Australia had its first contraction in 10 years of -0.6%.

Negative Drivers. Why the contraction? A number of factors depressed demand in 4Q00. These included:

- Higher taxes.
- Central Bank slamming on the brakes (with excessively higher interest rates to overkill suspected inflation from Olympic overspending).
- These negative drivers more than offset rising commodity prices.

Foreign Exchange Falls. The currency is grossly undervalued. Traditional relationships, such as movements in commodity prices, have unraveled.

- At 52 U.S. cents per Australian dollar, it is trading at 26% below its average of 70 U.S. cents over the past decade.
- The currency fell 13% in the first three months of 2001.

Currency Drivers. Why did the Aussie dollar get so weak?

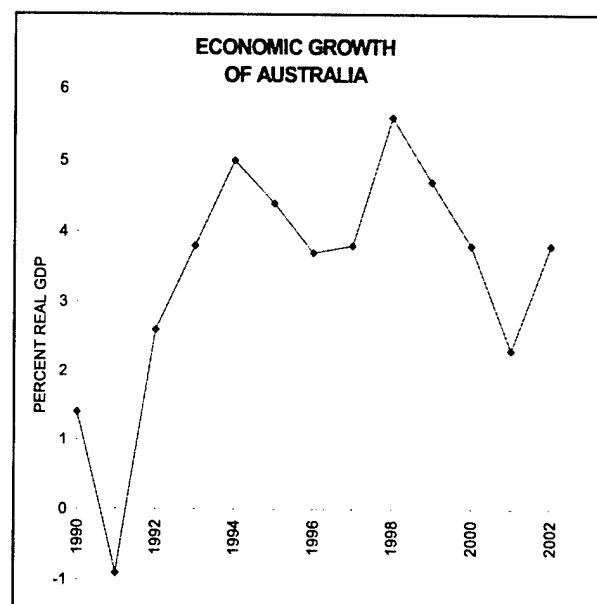
- Weak International Demand.** The two most important Aussie trading partners—the United States and Japan—are both struggling, thus providing little aggregate demand for Aussie exports. That means little commercial demand for the Aussie dollar.

Figure 5-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	382.7	380.6	380.8	394.0
Purchasing Power	362	377.4	426.4	501.5
Growth (%)	3.8	5.6	4.7	3.8
Inflation (%)	0.3	0.9	1.5	4.5
Exports	64.9	59.1	59.4	66.8
To U.S.	4.9	5.7	5.8	6.7
Imports	59.2	59.0	61.7	66.6
From U.S.	12.0	11.9	11.3	12.3
FDI from U.S.	26.1	33.7	34.8	35.3
In U.S.	11.7	10.5	13.2	14.5
Cur Account /GDP %	-12.8	-17.2	-18.6	..
Fiscal Balance /GDP %	-0.1	0.3	0.9	0.9
External Debt /GDP %	..	..	..	..

Sources: IMF, World Bank, U.S. Commerce

Figure 5-B



- Net Capital Outflow.** Financial factors are weakening the Aussie dollar. Capital inflows into Australia—both stock money as well as foreign direct investment—have fallen.¹ Local fund managers are diverting more Aussie investments abroad. In 2000, Aussie investors bought more and more U.S. stocks. In 2001 Aussie investors bought more and more U.S. government securities. All these trends reduced the demand for the Aussie dollar.

Bungled Tax Reform. The political economy in Australia has never really recovered from the introduction a year ago of a new tax system. The centerpiece was a tax on most goods and services in exchange for lower income and corporation taxes.

- The reforms were overdue, but it was poorly implemented.
- Small businesses complained about the high costs of complying with it.
- Elderly Australians on fixed incomes felt left out of the prosperity being enjoyed by younger wage earners.
- The budget surplus was whittled down to just A\$1.5B (US \$780M).
- Spending on new measures rose to A\$4B.
- The budget also committed more money to help small businessmen buy cars, the unemployed to find jobs, and people in the countryside to get health care.

Saying No to Shell. In April 2001 the government rejected Shell's bid for Woodside Petroleum, Australia's largest-listed oil and gas group.

- The government turned down Royal Dutch/Shell's A\$10B bid for Woodside, the country's largest independent oil and gas group. Shell was seeking to lift its stake in Woodside from 34 to 56%.
- The decision locked out a foreign company from one of the most important asset sales in many years.

Mixed Reviews. On the one hand, those Aussies who feel they are helpless victims of globalization generally supported the rejection of Shell. On the other hand, the market reacted negatively with the perception that the government was retreating from an open economy.

- The decision certainly was not received well outside of Australia. The currency and stock prices fell on 23 April 2001 announcement.
- It further alienated international investors, who tend to dismiss Australia as an old economy. The decision also reinforced growing fears that an isolated Australia will be a loser from globalization. In short, investors feel that it will harm Aussie economic fortunes.
- The decision also sets a bad example to developing economies across Asia as they struggle to reconcile the need for growth with a resurgence of anti-globalization sentiment.

Economic Good News

But all is not gloom and doom. Recent economic indicators are positive. In other words, the worst may be over.

- Growth for the year 2001 was 2.3%.
- Australian consumer confidence increased by a record 14.8% in June to 108.4, its highest level since August last year.
- Business confidence is also picking up. Building approvals have been strong.
- The current account deficit shrank from 6.1% of GDP in September 1999 to 1.6% in September 2001.

Rising Farm Production. Australian dollar grain and oilseeds prices are soaring.

- Australian wheat prices are trading at record levels. Barley prices are at records and canola (cooking oil) is near its all-time highs.
- Livestock prices are also high.
- The net value of farm production is forecast to rise nearly 16% in 2001-02 following a 34% increase last year.

Rising Export Earnings. Australia's commodity exports are set to rise 5% to a record A\$92.6B (US \$48.4B) in 2001/02.

- This is the third consecutive year of record commodity exports and the expected 2001/02 increase would follow a 23% rise last year to A\$88.6B.
- Exports are booming mainly because of the persistently weak in Australian dollar.
- But exports are expected to rise in 2002.

Rebound in Housing. Australia showed an unexpectedly sharp rebound in housing, a sector that had been a drag on the economy for several months. Lower interest rates and an expanded first-home owner's scheme have lit the fuse under housing construction.

The U.S. Economic Factor. Therefore, the worst appears to be over for the Aussie economy. But it's too early to celebrate a durable recovery. At a minimum, the durability of this upswing will be severely tested by U.S. economic stagnation and recession seeping across other Asian economies.

Conclusion

The poor Aussie economic performance that the country experienced in the fourth quarter of 2000 and first quarter of 2001 is giving way to good news in recent months.

- On the negative side, the Australian dollar is at a new low of 52 U.S. cents.
- On the positive side, the economy is back on the growth track with GDP up 2.3%.
- Consumer and business confidence are both picking up. Grain prices are rising, export earnings are improving and housing is on the rebound.
- Stagnation and recession in the United States, Japan, and the rest of Asia are still causes for concern.

How has the Australian government managed the economy?

- Over the last decade or so, the Aussie government's management of the economy has generally been positive. Its economic reforms establish a strong foundation for long term economic growth.
- Of course, the economic contraction and the fall in the Australian dollar made things politically difficult for the government. In 2001 popular support for the government coalition was at its lowest level since 1994.

On the other hand, the Aussie economic governance could have been better.

- The government coalition has taken only a few actions to reduce the budget surplus.
- Further, the government also rejected Shell's bid to buy Woodside Petroleum.
- The market is concerned about how some of the government's recent policies alienate U.S. and other foreign investors.
- The market would prefer to see the Aussies follow economic policies that attract and retain foreign investment, thus strengthening the Australian dollar in the process.

Endnotes

¹ To be fair, the stock of foreign direct investment in Australia still remains higher than direct investment by Australian companies overseas. However, the outward flow is increasing faster than the inward flow.

CHAPTER 6

BANGLADESH

Introduction. Despite prolonged political unrest, periodic social upheavals and rising lawlessness, the poverty-ridden Bangladesh economy is gradually moving in the right direction. But progress is slow due to poor governance. Stronger, more dynamic political leadership could make a big difference in speeding up long term economic growth.

Dirt-Poor Economy. At first glance, Bangladesh appears to be just another poor third world country.

- With a per capita income of \$380, the country is extremely poor.
- It has a 52% illiteracy rate.
- It's overcrowded, with a woefully inadequate infrastructure.
- But the negative stereotypes, while founded in reality, are a bit misleading and don't tell the whole story about Bangladesh.

Progress. Existing stereotypes fail to convey Bangladeshi progress over three decades.

- The country attained near self-sufficiency in food production in 2000.
- Micro-credits empowered women and triggered entrepreneurial success stories.
- In the 1990s, it achieved an average GDP growth rate of about 5%. GDP grew 4.7% in 2001.
- Inflation is a low 1.8% and population growth has slowed to below 1.6% a year.
- The government is also increasing its tax revenue. Dhaka's revenue rose by about 21% between July and October 2000, thanks to tougher enforcement of tax collection. This has reversed the deteriorating trend in revenue collection that had been prevalent in recent years.
- These are substantial achievements by any standards.
- And the country has great potential. It has virtual oceans of natural gas.

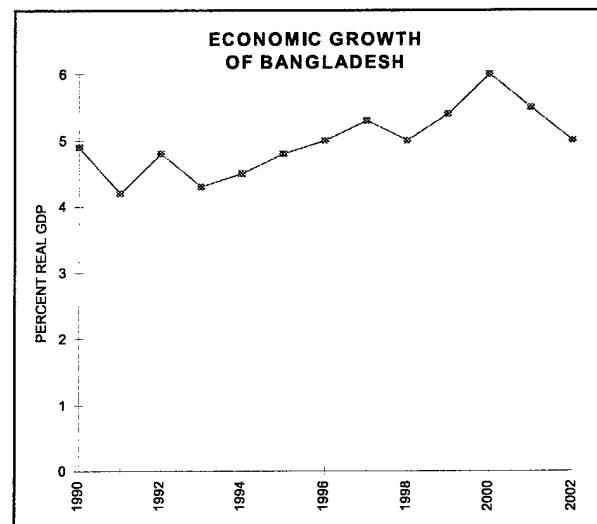
Not Enough. That said, the country could be doing a lot better. The problem is largely poor economic governance, with sloppy implementation of policy decisions.

Figure 6-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	44.1	44.0	47.0	47.9
Purchasing Power	135.0	175.5	188.3	206.1
Real Growth (%)	5.3	5	5.4	6
Inflation (%)	5.1	8.5	6.4	2.3
Exports	4.3	5.0	5.2	5.5
To U.S.	1.8	1.9	2.1	2.5
Imports	7.0	7.3	7.8	8.1
From U.S.	0.3	0.3	0.3	0.3
FDI from U.S.	0.086	0.171	0.145	0.215
In U.S.	0.002	0.003	0.003	0.002
Cur Account /GDP %	-2.1	-1.1	-1.4	-1.6
Fiscal Balance /GDP %	-4.3	-4.1	-4.8	-6.1
External Debt /GDP %	34.6	35.9	37.1	..

Sources: IMF, World Bank, ADB, U.S. Commerce

Figure 6-B



- Economic policy focuses more on form than substance. So there's lots of rhetoric but little strategy formulation and action.
- As a result, the country's potential for achieving a higher growth rate has not been properly harnessed.

Macroeconomic Mismanagement. Macroeconomic management, which has historically been a strong point in Bangladesh, shows signs of deterioration.

- Indeed, the government's budget deficit increased from 4.8% of GDP in 1999 to 6% in 2001.
- Dhaka has been pumping up spending on public projects ahead of new general elections expected sometime this year.

- As a result, domestic financing of the budget increased to 3.3% of GDP in 2000 from less than 2.5% in 1999.

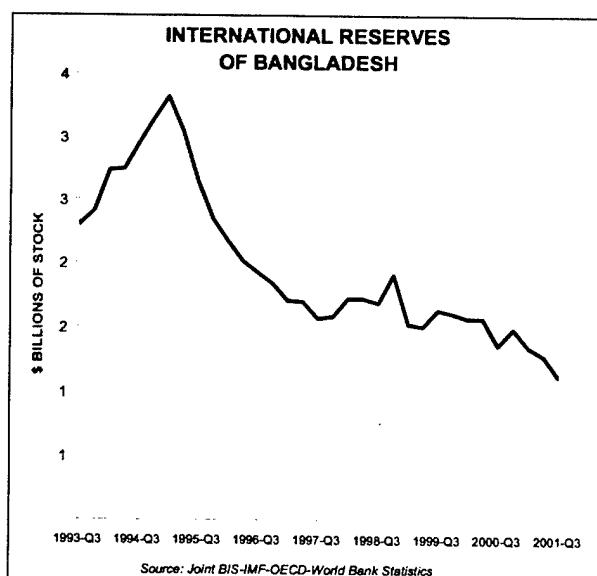
Over-borrowing. This was achieved by increasing the government's share of bank borrowing through the issuance of various public-savings instruments.

- Higher government borrowing, however, has not caused any "crowding out" of private credit.
- That's because broad money growth shot up by more than 19% during 2000 as the government printed more money to make up for its borrowings from the country's financial system.
- If this growth of the money supply persists, this action risks stoking inflation, although there's little evidence that this is happening so far. Inflation between January and September was only 2.7%.

Good News: Exports. On the external front, Bangladesh's exports in the same period shot up a healthy 27.2% year on year, led by garments, while imports rose by about 14%.

- Still, the country's foreign reserves declined below \$1.4B to less than two months of import cover as of mid-December. (See Figure 6-C.)
- In other words, domestic investors are getting jittery and opting for capital flight.

Figure 6-C



Devaluation. The currency was devalued 6% in August 2000 from 51 to 54 Taka per U.S. dollar, and reached 57 by the end of 2001.

Higher Energy Prices. The government has lately tried to get public utility prices right, despite the political unpopularity of the move.

- Natural gas prices have been increased by 15% and oil prices by 9%-20% in August.
- Bangladeshi officials say the exchange-rate adjustment, mounting budget pressures, and substantial leakage through smuggling of petroleum products to India makes these adjustments an immediate necessity.

Outlook

Given current economic trends, Bangladesh will likely come up short in providing the economic governance needed for the country to achieve 7 % to 8% growth rates. Such high growth rates are needed if the country is ever to surge ahead and make a serious dent in poverty reduction.

- Government actions belie its investor-friendly words.
- Potential investors will likely see the country as an unattractive place to do business. As a result, desperately needed foreign direct investment will probably only trickle in.
- Sadly, the country's immense agricultural and natural gas resources will be ineffectively utilized.
- In short, despite some progress over the years, the current economic strategy shows no signs of establishing the economic conditions needed to be another Asian tiger.

Conclusion

Bangladesh has made considerable economic progress over the years. Its self-sufficiency in food production is impressive. However, Bangladesh could do much better by attacking its foremost problem, poor economic governance. With better economic governance, Bangladesh could attract more investment and growth and make bigger dent in poverty reduction.

CHAPTER 7

BRUNEI

Introduction. The 1997-98 economic and financial crisis that swept through the Asian region devastated Brunei's small economy.

- Oil revenues declined in 1998 to 1999, but are now stimulating growth.
- Its non-oil economy went into a recession, from which it is still trying to recover.
- To offset lost demand, the government ran a large fiscal stimulus package, but it is now reducing government programs and spending.

The Economy and Trade

Rising GDP. GDP has been incrementally rising in years following the Asian economic crisis.

- The growth of GDP in real terms for 2000 was 2.5%, compared to the more robust average of 3.5% before the crisis.
- Depressed world oil prices from 1998 through 2000 also contributed to the decline of GDP growth.
- The second largest contributor to real GDP growth is the construction sector. However, fiscal consolidation measures greatly reduced the construction sector, and are having spillover effects on related sectors such as transport and communication.
- The budgetary cuts released in 2001 will dampen construction growth prospects and the outcome in real terms for the other sectors will follow suit.

Oil and Gas Exports. Rising oil prices have predictably boosted economic growth.

- Over 90% of Brunei's exports are crude oil and natural gas.
- The recent plunge of the Singapore currency to an 11-year low against the US dollar means that Brunei oil and gas exports — traditionally quoted in the US currency — will increase in value.
- As a result, Brunei's oil and gas exports are expected to earn more than \$4 billion in oil and gas export this year.
- This figure could be an all-time high (a rise of 8% over the figure for 2000).

Figure 7-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Real GDP	7.5	..	2.5	..
Purchasing Power	..	5.4	5.9	..
Growth (%)	4.1	1.0	1.0	3.0
Inflation (%)	1.7	-0.4	2.0	..
Exports	2.360	2.002	2.300	..
To U.S.	0.058	0.224	0.422	0.408
Imports	1.873	1.358	1.300	..
From U.S.	0.178	0.123	0.069	0.145
FDI from U.S.	0.010	0.062	0.018	0.026
In U.S.	..	..	..	..
Cur Account /GDP %	49.0	55.4	..	..
Fiscal Balance /GDP %	..	..	..	..
External Debt /GDP %	..	..	..	..

Sources: IMF, CIA, World Bank, ADB, U.S. Commerce

Figure 7-B.

Brunei's Statistics. Brunei's wealth has led to a complacency in maintaining fresh economic statistics. As a result, Brunei finds it difficult to monitor economic progress and to target economic policy. A key step forward would be the implementation of the "IMF Standards for Data Dissemination."

Imports. Brunei depends largely on imports. Since the Brunei currency is pegged to the Singapore dollar, the recent fall of the Singapore dollar means that Brunei's exports are now much more expensive. That fans inflation as well.

Trade Balance. Brunei's overall trade balance is favorable. Imports in the past couple years have fallen much more than the rate of decrease of its exports of crude oil and natural gas.

East Asia Growth Area (EAGA). Brunei belongs to the EAGA that also includes neighboring—but (economically laggard—provinces (i.e., Kalimantan, Sulawesi, Maluku, and Irian Jaya in Indonesia; Sabah, Sarawak, and the Federal Territory Labuan in Malaysia; and Mindanao and Palawan in the Philippines).

- On the positive side, the exports in intra-EAGA trade are expected to grow 7.4% to 7.9% as the small economy of Brunei has relied more so on intra-regional trade with ASEAN and EAGA and extra-regional trade has been secondary.

- The EAGA is designed to liberalize state-run companies over the long-term.

AFTA. The ASEAN Free Trade Agreement (AFTA) will spur trade in the region as the economies become more liberalized.

- AFTA promotes the free movement of goods between Brunei and ASEAN.
- It creates a comparative advantage for regional sub-groupings (i.e., EAGA) that have not been traditionally explored.

Economic Challenges

Small Size. Brunei's small size puts it at a disadvantage in the region.

- It has no central bank.
- Its high prices and its small size make the economy an unattractive location for foreign businesses and tourism.
- Even as a member of ASEAN, Brunei's economy is still too small as it struggles to compete at the ASEAN level.
- Thus it has relied on the smaller-scale EAGA to spur trade and business.

Oil Dependence. Not surprisingly, Brunei's economy is largely dependent on oil revenues.

- Oil accounts for 40% of its GDP and 90% of its exports.
- The private sector is the largest customer for the 200 thousand barrels of oil Brunei produces every day.
- Oil sales also constitute the government's chief source of revenue.

Government Employment Glut. About 42% of the Brunei population work for the government. The government cannot expect to reduce the budget deficit while maintaining a government workforce this large.

Low Investment Capital. The low level of awareness on AFTA open-market reforms have failed to make the private sector the engine for growth, as previously hoped.

- Coupled with the relocation in February 2001 of the secretariat office of EAGA from Brunei to Sarawak, business development will be less than robust.

- There are little in the way of incentives and opportunities for foreign investors in a small market economy.
- A recent agreement between the government and several local banks to provide loans to local entrepreneurs will add to the long-term development and commercialization of Brunei.
- Foreign investors are reluctant to invest in Brunei.
- The long approval process and high government wages tends to dissuade most investors from investing in Brunei.

Sultan Control. In a healthy free market economy, economic decision-making is largely decentralized. In contrast, Brunei's economic decision-making is over-centralized. As a result, bottlenecks develop and hamper Brunei's economic progress.

- On the positive side, Brunei's February 2001 development budget report indicates that excessive government spending on business development was halved.
- On the negative side, a figure of \$1.2 billion was allocated for "miscellaneous services."
- Therefore, when it comes to resource allocation, the government therefore needs much more accountability and increased transparency.
- While the government's Economic Secretariat announced several schemes to rekindle the business atmosphere, the impact in real terms is still to be realized.

Economic Reforms

In response to the devastation of the Asian crisis, the sultan is trying out economic discipline by instituting two broad kinds of reforms:

- Reforms to incorporate Brunei in the global economy.
- Reforms to wean it from a long over-dependence on oil and government money.

Private Sector. The reforms, which are part of the AFTA, are designed to make the private sector the engine of growth.

- The government has made significant progress in keeping with its commitment to open up and free the economy of tariff and non-tariff barriers.
- The government wants to spur the private sector with low-interest loan incentives to local businesses and corporate tax exemption for foreign investors.
- Government-run companies have been privatized and many more are on the table.

Government Sector. In addition, the government is developing other initiatives.

- The economic stimulation package that responded to the Asian economic crisis ran up a large budget deficit of 6% of GDP. This was cause for financial concern.
- So to facilitate long term economic growth, the government is cutting back government spending and subsidies, privatizing government-run agencies and finding new resources of revenue. The hiring of government employees is frozen.
- The Brunei government in February 2001 slashed its government spending by half compared to the year before. These budget cuts are in line with the Economic Secretariat's drive to open up the economy and to stop the "crowding out" of private sector spending.
- To be less dependent on Shell, the government is creating a national oil company to explore for oil and refine it.

Conclusion

Good News: The economy is on a recovery path as the government moves ahead with a few new economic reforms and liberalization schemes.

Bad News: The combination of dependence on oil imports and over-reliance on central management hurts Brunei's economy.

- Brunei is still heavily dependent on oil revenues and imports. These imports make Brunei susceptible to external inflationary conditions. Furthermore, the oil reserves are near depletion. Consequently, Brunei needs to diversify markets and practice economic discipline.

- The Sultan runs everything. Therefore, most decisions are over-centralized. In addition, Brunei still has a glut of government employees and runs a high budget deficit.
- Brunei is also a small, developing economy with overly high prices.
- It presently lacks the potential, at least short-term, to lure foreign investment.

Recommendations. Brunei needs to continue with its privatization policy, inject sufficient capital outlays to sustain growth and private sector, maintain price stability, enhance government transparency, reduce government labor; encourage the investment climate, and lure foreign direct investment.

CHAPTER 8 CAMBODIA

Introduction. Cambodia—one of the poorest countries in the world—continues to struggle.

- In 2001 the economy is achieving only a 4%-4.5% growth rate, compared with an initial target of 5.5%.

Economic Aftermath of War

No Dent in Poverty. This 4% figure is well below the 7% - 8% required to make a real dent in poverty.

- Cambodia's poverty rate—estimated at 36% of the population—is not budging.

Not Enough Jobs. Nor is the 4% growth rate high enough to absorb Cambodia's rapidly growing labor force.

- The garment industry—which accounts for 90% of the country's exports—only employs about 100,000 people, less than the estimated 150,000 new entrants to the job market each year.
- Admittedly, the country's rice farmers have produced a surplus this year in spite of severe flooding late in 2000.
- Yet foreign investment projects, which could be a means of modernizing the agricultural sector, slumped dramatically from \$41M in 1999 to \$4M in 2000.¹

Homegrown Projects? Given the disinterest of foreign governments, Cambodia needs to make a greater effort to develop its internal capacity to fund its own development projects.

- But indigenous projects are a non-starter until Cambodia develops more efficient tax collection.
- It will also be hard for the government to boost tax revenues without tackling corruption.
- Foreign businesses in Phnom Penh already complain that they pay their fair share, while local companies pay almost nothing.

Figure 8-A. Selected Historical Data

	\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	3.2	2.8	3.0	3.2	
Purchasing Power	13.0	7.8	15.1	17.2	
Real Growth (%)	3.7	1.8	5	4	
Inflation (%)	8	14.8	4	1	
Exports	0.9	0.9	1.0	1.3	
To U.S.	0.1	0.4	0.6	0.8	
Imports	1.1	1.1	1.2	1.5	
From U.S.	0.02	0.01	0.02	0.03	
FDI from U.S.	0	-0.001	-0.003	0	
In U.S.	-0.002	0	0	0	
Cur Account /GDP %	0.7	-0.3	-1.7	-4.6	
Fiscal Balance /GDP %	-0.4	-2.7	-2.0	-7.0	
External Debt /GDP %	70.0	77.7	73.3	..	

Sources: IMF, ADB, World Bank, U.S. Commerce

War-ravaged Economy. To be fair, Cambodia is struggling to dig itself out of a huge economic hole.

- Decades of war virtually destroyed the Cambodian economy.
- This dismal situation slowly began to change following the end of civil conflict and UN-sponsored elections in 1993.

Economic Transition. The country made meaningful progress in the transition to a market economy.

- Economic reform supported macroeconomic stability and increased trade and investment flows.
- Between 1993 and 1996 economic growth averaged a commendable 6%.
- Inflation, which had averaged 140% a year during 1990-92, was reduced to single digits during 1995-97.
- Per capita income doubled, from about \$150 to nearly \$300 in 1997.

Political Insecurity

Political Vulnerabilities. Yet below the surface, all was not well.

- Externally, Cambodia's economic growth relied too heavily on the East Asian economic miracle for exports markets, large foreign savings and trade tax receipts. In short, it was overly vulnerable to the Asian economic crisis.
- Internally, the reform momentum in Cambodia slowed considerably in 1997.

- A coup led by Hun Sen, Cambodia's current Prime Minister, threw the country into turmoil.
- As a result of this political instability, Cambodia's structural reforms lost steam during the first half of 1997 and decelerated considerably in the second half of 1997.

Economic Impact. The impact of political insecurity on the economy was significant:

- GDP fell 1.7% in 1998, but then grew 5% the following year.
- Governance problems exacerbated public finances.
- Donors began to halt disbursements.
- Too many weak banks undermined the financial system.
- Cambodia's currency, the riel, lost value.

Falling Foreign Direct Investment (FDI). Private investor confidence also weakened.

- Investment flows dropped by an estimated 45% drop in 1997.
- New investment commitments fell by roughly 35% in 1997, compared with 1994-1996.
- The decline of investment flows to Cambodia in 1997 was caused by two dramatic events in July 1997: the fall of the Thai baht and the overthrow of First Prime Minister Prince Norodom Rannaridh, including the subsequent domestic political upheaval.

Double Whammy. In 1998, the economy fell victim to a similar double whammy:

- The recessionary impact of the Asian economic crisis.
- The uncertainty and political instability surrounding the national elections in November of that year.

Mitigating Factors. Fortunately, Cambodia was partially insulated from the worst of the Asian economic crisis:

- It received virtually no volatile, short-term capital flows.
- Garment exports to the U.S. and Europe remained strong, thus boosting currency reserves.

- De facto dollarization of the economy—70% - 90% of all transactions in U.S. dollars—helped to limit inflationary and exchange rate shocks.

Responsible Fiscal Policy. Since the Asian economic crisis, Phnom Penh has demonstrated fiscal restraint.

- Responsible fiscal policy has helped to limit recourse to excessive bank financing.
- It has also kept inflationary pressures in check.

A New Political and Economic Era

Stability and Growth. The collapse of the Khmer Rouge as a threat and the formation of Hun Sen's coalition government ushered in a new era of stability. After years of conflict and political instability, the poverty-stricken country of Cambodia is starting to dig itself out of a deep economic hole.

- While it will take years to repair the damage inflicted by decades of conflict, Cambodia experienced two years (1999 and 2000) of renewed, albeit less than spectacular growth.
- During this period, Cambodia has been slowly but surely moving beyond simply relief and post-war rehabilitation.
- Despite severe floods and an oil shock, Cambodia's macroeconomic discipline and generous donor aid are successfully keeping the economy afloat.

Progress in 1999. The relative calm of 1999 helped the economy exceed expectations. For instance:

- Cambodia increased economic growth to a relatively strong 5.0% in 1999 due to:
 - continued expansion of garment exports and
 - a 40% jump in tourism revenues—to \$90M in 1999 from \$64M in 1998.
- Inflation was tamed, dropping to 4% in 1999 from almost 15% in 1998.
- The currency, the riel, remained stable at about 3,800 to the U.S. dollar.
- Government revenues rose to \$346M or 11% of GDP, in 1999, up from \$247M in 1998.

Bad News: Falling FDI. On the negative side, attracting FDI is proving tough for Cambodia. The coalition of former foes forged amid the acrimonious aftermath of the 1998 election is having slim success in wooing foreign investors back.

- FDI commitments in 1999 totaled just \$482M, little more than half the level of the mid-1990s.
- FDI continued to be low in 2000. In the first nine months of 2000, FDI was \$213M—the lowest since the political turmoil of the early 1990s.
- The figure for the same period in 1999 was \$230M.

Factors Behind Low FDI. Why has FDI remained so low?

- People are unwilling to invest long term, largely because there is no rule of law. There is no independent judiciary, so if there is a problem with a contract, there's no recourse.
- In addition to this poor legal framework, many potential long-term investors are deterred by poor infrastructure, a lack of skilled labor, corruption, and widespread problems over land ownership—a remnant of years of war and Cambodia's tragic past under the Khmer Rouge.

Budget/Donor Link. Weak economic governance in Cambodia also turns off foreign investors. Take governance of the budget, as an example.

- Revenue performance has been very poor. This shortfall, which is due to poor tax collection and compliance, limits the government's capacity to increase public spending.
- Faced with this shortfall, foreign assistance must fill the gap, which represents 61% of government expenditure.
- Money in the budget is also misallocated.
- The government still spends almost 50% of its budget on security and defense, a staggering figure for a weak developing economy.
- Excessive military spending is a serious opportunity cost that crowds out spending

on health, education, and rural development.

- Spending on health, education, and rural development is lagging in 2000, as was the case in 1999.

Good News in 2000. In many ways, however, Cambodia's economic performance was commendable in 2000. For instance:

- Inflation was non-existent.
- The exchange rate of the riel was stable at around 3,880 to the U.S. dollar.
- Foreign exchange reserves (currently equivalent to three-and-a-half months of imports) was adequate.
- The government's budget deficit was manageable.

Flooding. Unfortunately, floods hit Cambodia in September 2000. The impact was significant.

- The rising waters of the Mekong River produced the worst floods in 80 years.
- 3 million people—out of a total population of 12 million—were affected by the floods.
- At least 252 Cambodians died and 1.3 million were left in urgent need of food, shelter and medicine.
- Flood damage affected 102 irrigation projects, 988 schools, 121 clinics, 2,200 kilometers of road and over 544,000 hectares of rice land.

Costs of Flooding. The flooding required emergency finance of between \$30M and \$35M to carry out repairs. The total damage was in the ballpark of \$79M.

- These are not huge sums by international standards, but significant in a country that is still recovering from decades of destruction linked to war and genocide.
- The floods have also hit trade with neighboring Thailand and, thus, the collection of customs revenue along the border.

External Support

Jittery Investors. Meanwhile, investor confidence, which had been ebbing, has now dried up because of the authorities' impotence in the face of the flooding.

- International relief agencies, not the government, took care of the victims.
- The absence of good governance continues to haunt this country.

Donor Support. The floods made Cambodia even more reliant on external assistance to help stay afloat.

- ADB's loan portfolio in Cambodia now totals almost \$500M.
- The IMF resumed loans to Cambodia in October 2000, while the World Bank continues its support.
- In May 2000, bilateral and multilateral donors pledged \$548M in aid to Phnom Penh.

Donor Aid/Budget Link. Cambodia remains heavily indebted to the World Bank and ADB. In fact, its addiction to foreign aid is more comparable to the desperate plight of some sub-Saharan African nations than Asia's growing economies.

- For instance, in 2000 the entire budget deficit of 637B riel (\$166M) was covered by foreign aid.
- And external contributions as a proportion of Cambodia's GDP keep rising: 11.7% in 1993, 14.4% in 1999, and 16.4% in 2000.

More Charity? The fifth meeting of the Consultative Group—which brings together the major bilateral and multilateral aid agencies—is well aware of this negative trend. At a meeting in June 2001, Cambodia's finance minister, Keat Chhon, asked for continuing funding of \$500M for each of the next three years. In the end, he may get even more aid than that.

Quid pro Quo. But foreign aid is not a sure thing. It's conditional.

- It's dependent on the government implementing economic reforms.
- These include pledges to cut military spending, crack down on illegal logging in order to generate tax revenue from legal logging activity, and trim the bloated civil service payroll.

Reforms

Slippage in Reforms. Unfortunately, the government is slipping in key areas of economic reform:

- Social sector spending as of the end of August 2000 only reached 40% of annual IMF targets.
- Too much money is also spent on "asphalt farming." For instance, 86% of the national budget is spent in the capital, which is home to just 10% of the population.
- Not enough money is spent on rural development. That has hurt rice production, which is among the lowest in Asia.
- Cambodia still is not meeting IMF conditions on reducing the size of the bloated civil service.

Military Demobilization. IMF describes the status of Cambodia's military demobilization as "very worrisome."

- Unless the dithering pace of military demobilization speeds up, the government will be unable to meet IMF's condition of bringing security spending to below 2% of GDP by the year 2002.
- This will crowd out increased spending in the social sector.

Needed: Tougher Line. Cambodia is now faced with some tough conditions in return for foreign assistance.

- Donors are now expecting more than rhetoric and promises from the Cambodian government. The ADB is now calling for Cambodia to demonstrate a track record of concrete reforms.
- In short, Cambodia has to shape up or cope with a shrinking aid pie.

USG Role in Reforms. The USG has been unable to engage directly in the reform process.

- The USG should closely monitor Cambodia's performance under its economic reform program and try to persuade the International Funding Agencies (IFIs, i.e., IMF and World Bank) to hold a harder line.

- U.S. congressional restrictions—which require the USG to oppose IFI lending to Cambodia except for basic human needs—do not prohibit the USG from using its leverage with the IFIs to insist on better programs.

Conclusion

Wanted: More US Activism. The USG should consider the following:

- The U.S. can and should do more—even within the confines of existing congressional restrictions on assistance—to support military demobilization which is arguably one of the most important areas of Cambodia's economic reform program.
- The U.S. could tap into existing programs to provide in-kind assistance—food, civil engineering projects, medical assistance—to help support the demobilized soldiers and their communities, as envisioned in the demobilization program which the U.S. played a part in creating.

Endnotes

1 Cambodia Development Resource Institute (CDRI). CDRI is a private think-tank based in Phnom Penh.

CHAPTER 9

CHINA

Introduction. Although China exhibits remarkable economic growth, its weak financial system threatens long-term stability. China's accession to the World Trade Organization (WTO) promotes further economic growth, although several sectors like banking and state-owned enterprises (SOEs) find it difficult to adapt and become more efficient.

The Good, the Bad, and the Uncertain

Good News. At first glance, China appears to be on a roll.

- China's economic performance is reportedly the strongest among the world's larger countries.
- Foreign exchange reserves are robust.
- In July 2001 China was awarded the 2008 summer Olympic games, another shot in the arm to the economy down the road.
- In September 2001, China's WTO entry became a "done deal," with a quick Chinese ratification expected and entrance as early as the end of 2001.
- In October 2001 Shanghai hosted the Asia Pacific Economic Cooperation (APEC) forum, which attracted virtually all Asian political and economic leaders.
- In short, China is relishing their new international recognition, respect, and apparent economic power.

Bad News. Numerous negative economic trends heighten Beijing's anxiety.

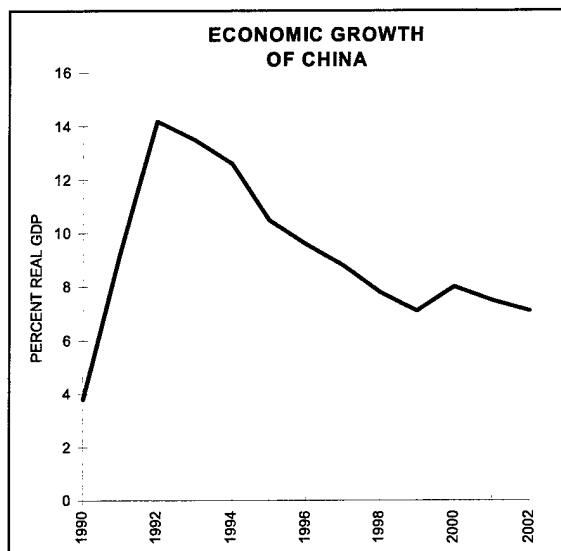
- Prior to 9-11, the global economic slowdown was triggering a severe slowdown in Chinese export growth.
- The terror attacks on the United States threw the United States and the rest of the major world economies into recession, or at least a severe slowdown.
- A weak global economy will hurt Chinese export performance.
- It will also curtail the flood of incoming foreign direct investment—notwithstanding WTO entry.

Figure 9-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	1055.4	928.9	980.2	1080.0
Purchasing Power	3770.0	3988.3	4112.2	5023.2
Real Growth (%)	8.8	7.8	7.1	8
Inflation (%)	2.8	-0.8	-1.4	0.4
Exports	182.8	183.8	195.0	249.2
To U.S.	65.8	75.1	86.5	106.2
Imports	142.4	140.2	165.7	225.1
From U.S.	12.8	14.3	12.9	16.0
FDI from U.S.	5.0	6.3	8.1	9.6
In U.S.	0.2	0.3	0.3	0.3
Cur Account /GDP %	2.2	0.9	1.6	1.9
Fiscal Balance /GDP %	-0.8	-1.2	-4.1	-2.6
External Debt /GDP %	16.5	16.6	15.9	

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 9-B



- As the external economic drivers weaken, pressure increases for Beijing to transform its fragile domestic financial underpinnings before they crack.

On the Brink. China stands on a threshold.

- On the one hand, WTO entry may be just the catalyst Beijing needs to catapult to a market economy across the board. But that's a huge leap. In this regard, WTO entry will be a gut wrenching transformation that could easily get out of control.
- China's financial system—one of the weakest in Asia—makes the transition especially difficult. If mismanaged, China's WTO entry could trigger Chinese social unrest, financial chaos, and political instability for China's fourth generation of political leadership.

Economic Miracle. For almost three decades China's export-led growth strategy appears to be an economic miracle:

- China is now the seventh largest economy in the world. Despite the U.S. and global economic downturn, China's GDP performance continues to be the strongest among the world's larger countries.
- GDP expanded on average 9.7% from 1980 to 2000. Economic growth was 7.1% in 1999 and 8.0% in 2000. In the first half of 2001, GDP reportedly grew 7.9%.
- Foreign exchange reserves stood at an impressive \$193.5B as of 15 September 2001. Chinese Premier Zhu Rongji says that foreign exchange reserves should reach \$200B by the end of the 2001.

Cooked-Up GDP. But all of these growth figures must be taken with a grain of salt.

- A February 2002 Chinese National Bureau of Statistics discovered 60,000 statistical violations, thus confirming Zhu Rongji's criticism of the statisticians for cooking the books to meet high GDP targets.
- PRC GDP also reflects "phony production" of SOE goods nobody wants—a huge oversupply avoided in market economies.

Low Baseline. China's growth numbers also look good because the economy was so backward to begin with back in 1979. The communists left it in ashes. Economic growth rates therefore look dramatic because the starting baseline GDP was so low.

Pockets of Poverty. Moreover, while coastal areas of China are relatively prosperous, large sections of interior China still remain desperately poor.

- The gap between rich and poor is now among the highest in the world.
- The closure of SOEs has impoverished many.
- There are 120 million people living below the poverty line and around another 150 million seasonally-employed migrant workers.
- And if one considers China's huge population, China tumbles down the country rankings to about number 150 as measured by GDP per capita.

Economic Drivers

Now let's turn to the major factors driving Chinese economic growth. All are faltering. These drivers include:

- Export Growth
- Foreign Direct Investment (FDI)
- Government Spending

Not an Island. China used to be considered an economic island immune from the ups and downs of the global economy. Not anymore. China's stakes in the global economy are high.

- Trade and investment now contribute more than 40% to China's GDP.
- One-fifth of China's exports go to each of the United States and Japan, both of which are struggling with an economic slump.
- Consequently China's growth is vulnerable to the U.S. and Japanese recessions that also threaten the rest of the world with recession or anemic growth.
- Weaker Asian growth—due to debt overhangs, high oil prices, and weaker demand for Chinese computers and consumer electronic exports—further weaken demand for Chinese exports.

Trade

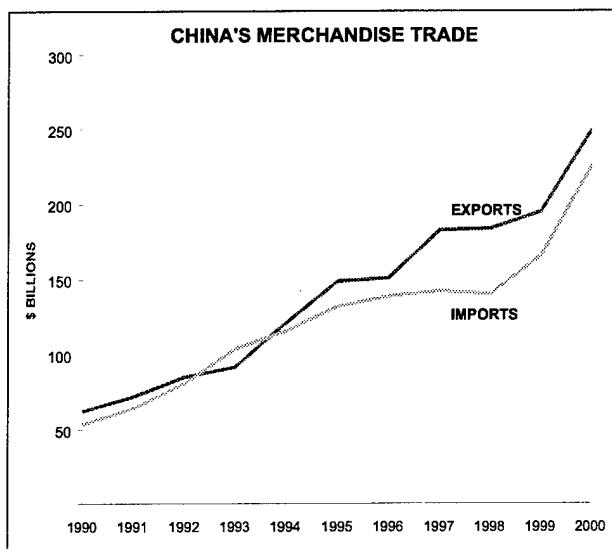
Exports Falling. In this regard, Chinese export led growth—while still a source of demand—is starting to lose its punch in late 2001.

- For the eight months to August 2001, Chinese exports worldwide only rose 7.3%, compared to a 34.6% increase over the same period last year.
- Terrorist attacks on the United States on 11 September accelerated the downward trend in export growth.

Falling Trade Surplus. Faltering Chinese exports are hammering the trade surplus. China is now experiencing the smallest trade surplus since 1996. (See Figure 9-D.)

- For instance, the trade surplus in August 2001 was \$1.38B, down by nearly 50% from \$2.54B a year earlier, after exports showed a mere 0.9% increase.
- The trade surplus of \$11.45B in September 2001 fell 32% from a year earlier.

Figure 9-D



Export Promotion. Beijing has pledged to employ "1,000 plans and 100 stratagems" to boost exports in 2001 and 2002. Unfortunately, the policy options seem limited.

- During the Asian crisis, it awarded successively larger value-added tax (VAT) rebates to exporters to offset a fall in their price competitiveness. But now VAT is rebated for exporters at an average of 15% of the maximum 17%, leaving only 2% available for further rebates. The government has been reluctant to further boost rebates, partly because of a huge fraudulent rebate claims scandal that emerged during the Asian crisis.
- Indeed, there are only a few alternatives:
 - One is to provide approvals for more private companies to export directly—cutting out export agents that reduce efficiency and charge significant fees.
 - Another is to assist exporters in identifying new markets away from the United States and Japan.

Devalue? China's faltering export performance rekindles the ongoing debate over whether China needs to devalue its currency to boost export competitiveness. But, as in previous years, there are several reasons not to devalue. China may be keen on claiming the international kudos it won during the Asian crisis for refusing to devalue despite clear pressures on exports.

Rising Imports. China's faltering trade surplus reflects rising imports as well as falling exports. Why are imports going up?

- Imports into China are surging as domestic companies prepare for the post-WTO competition by upgrading plants and machinery.
- China's robust demand for imports will be reinforced by WTO entry because falling tariffs will trigger a flood of imports.

Possible Capital Flight. Chinese import inflows and capital flight are related.

- Imports put pressure on Beijing to devalue to make Chinese exports cheaper.
- People & companies inside China, fearful of devaluation, may move money out of the country, thus making devaluation a self-fulfilling prophecy.

Imports and Layoffs. Imports may also trigger a flood of layoffs.

- Lay-offs over the next five years could amount to 20% of SOE workforce.
- WTO entry will make reform of industrial and financial sectors more urgent as markets open to foreign competition.

Foreign Investment

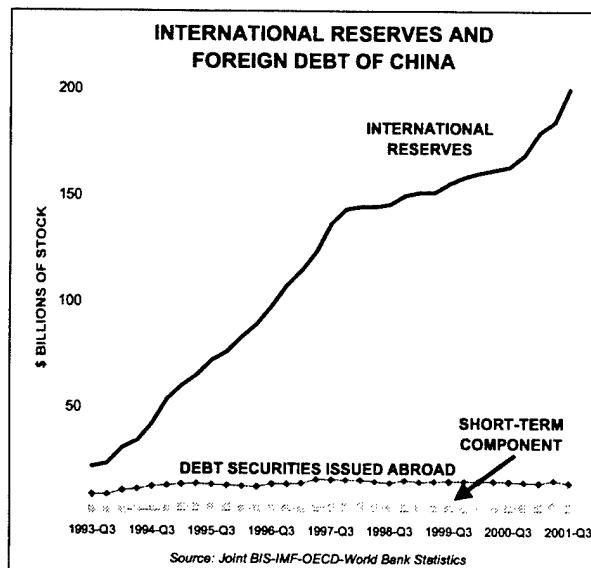
Rise of FDI. Back in 2000 FDI was pouring into China. The spike-up in FDI reflected investor frustration with slow reforms in ASEAN economies. China was winning "head to head" FDI competition with ASEAN.

- China received 61% of the FDI coming to developing Asian economies, in contrast to just 18% a decade ago.
- In contrast, ASEAN economies received just 17% of FDI that flowed to developing countries in Asia, down from around 61% in the early 1990s. Obviously China was doing something right.
- No other Asian country could match the potential of China's vast home market, its huge pool of low-cost labor, and its growing class of educated technocrats.

Fall of FDI. The tables may now be turning—at least in the short run. FDI is no longer pouring into China. Why not?

- The U.S. recession, coupled with a host of new fears stalking corporate America, is expected to delay several of the overseas investment plans of American corporations.
- In addition, the 9-11 terrorist attack on the United States is having a negative impact on FDI coming into China.
- In the longer term, it is the damage to China's expectations of a flood of inward investment following its accession to the WTO that could be set back the most by the terrorist attacks.
- As cited earlier, foreign investment and trade together account for over 40% of China's GDP. So a significant decline in both could jeopardize China's rapid growth.
- Foreign debt is moribund despite healthy international reserves. (See Figure 9-E.)

Figure 9-E



Private Domestic Demand?

Demand Doldrums. Let's turn first to whether or not China can offset these negative external shocks with stronger, domestically-driven demand. The prospects of China generating homegrown, self sustaining, high-quality economic growth are not good. Why? In healthy market economies, private sector demand drives most of the economic activity. But in China, consumer spending growth has been near zero for many years. Why is private demand in China so weak?

- In rural areas, the growth of rural incomes has also slowed dramatically.
- 100 million unemployed rural workers & 18 million unemployed urban workers don't spend much money.
- Millions of other Chinese are worried about losing their jobs.
- Even those workers with job security face crushing, new bills due to rising costs in housing, education, and health care.

Saving Too Much. In the face of uncertainty, Chinese households save rather than spend.

- From 1992 until 1995, the Chinese consumers spent 78% of their earnings and saved 22% of earnings.
- In recent years, Chinese consumers have spent only about 60% of their earnings and saved 40% of earnings.

Consumption Incentives Fail. In hopes of boosting sluggish consumption, Beijing has tried a number of things. Beijing resorted to lower interest rates, disincentives for savings, lower taxes, higher wages, welfare handouts, and increased provision of consumer credit. None have been terribly effective.

Price Deflation. Reluctance of consumers to spend has been one of the main reasons for the price deflation since October 1998. Overcapacity and oversupply are also worsening deflation.

- Beijing has taken administrative actions to curb price deflation. These socialist tactics include administrative adjustments in service sector prices for education, health care, housing rentals, and water.
- But in the private sector the prices of food, clothing, building materials, consumer electronics, and manufactured goods continue to show disturbing declines.

Government Spending

Government Overspending. In hopes of offsetting the fall in private demand and maintaining high levels of growth, Beijing has opted for stop-gap spending. In fact, for the last four years, the main engine of GDP expansion has been a huge, increasingly controversial fiscal stimulus program.

- The government appears committed to continue infrastructure projects financed from state coffers and state bank lending.
- China has had considerable difficulty servicing its current high levels of public debt.
- And yet Beijing plans still another fiscal stimulus above and beyond the Rmb150B planned for 2002.
- Unfortunately, this kind of year-after-year over-spending weakens China's fragile underpinnings and is unsustainable.

Financially Unstable Government. Publicly, the government claims its finances are viable.

- For instance, official figures show domestic debt at only 15% of GDP. But this is creative accounting at its worst.
- If contingent liabilities in the form of bad debts in state banks, unfunded state pensions, and social welfare liabilities are counted, public sector debt levels quickly climb to near 100% of GDP.
- If the Maastricht rule of thumb is applied—that public sector debt over 60% of GDP is financially unstable—it's clear that China's public finances are dangerously high and unsustainable.
- In other words, China's so-called economic power rests on financial quicksand.

Banking

Mountain of Non-Performing Loans (NPLs). The greatest structural weakness in the Chinese economy is the level of NPLs in the domestic banking system. In this regard, the balance sheet of the state run banks looks even worse than the government's fiscal balance sheet.

- In fact, the Chinese state-run banking sector is one of Asia's weakest.
- According to Beijing, the NPL ratio of the Big Four state banks is 30% of assets.¹ More objective private financial analysts say NPLs represent 50% of the total assets of the Big Four banks. Even using the more conservative official figure for NPLs, credit rating agencies such as Fitch IBCA and Moody's say the Big Four state banks are technically insolvent.

- Since the Big Four banks account for around 80% of total assets in the domestic financial system, such fragile underpinnings pose a serious crisis of confidence in the country's biggest banks.

Bank Bailouts. Beijing is well aware of the negative impact that its mountain of bad loans has on the financial system and the wider economy. In fact, the central bank is pursuing the Herculean task of clearing up the system and strengthening the Big Four.

- The government issued Rmb270B in bonds to bolster bank capital in 1998.
- It is also the implicit guarantor of Rmb1,400B in bonds issued by four Asset Management Companies (AMCs) that took an equal amount of NPLs off the books of the Big Four in 1999 and 2000.
- But how long can China keep these bailouts going? When is the day of reckoning?

Banking Crisis? Chinese officials tend to dismiss such fears of a banking crisis. They say the risk of a banking crisis is rendered remote because all the Big Four banks are owned by the finance ministry and enjoy an implicit sovereign (government) guarantee. But actually, government guarantees provide little comfort. Why not?

Government Tapped Out. We've seen that the government is also over-borrowed and faces a severe fiscal crisis. The Chinese government is in no position to keep spending the kind of money needed to indefinitely bailout the state run banks. The Big Four banks cannot keep pouring money down the rat's hole of SOEs that insist on their right to destroy the savings of the Chinese people.

- Even if the government could come up with the capital, the bank bailouts create a moral hazard. Bank bailouts encourage more-and-more reckless loans from the state run banks to the sick and inefficient SOEs.

Slows Bank Reform. In addition, the financially weak state-run banks are frustrating the course of financial liberalization and banking reform. Why?

- If the Big Four banks are subjected to free market competition too early, Beijing fears they will lose deposit and loan business to domestic and foreign competitors.
- The Big Four banks also risk collapsing under the sheer weight of their bad debts.

Financial Dithering. For this reason, financial reforms are being implemented incrementally—and those that are considered too risky are diluted or put off.

- For instance, a move unveiled last year to liberalize interest rates within three years has been delayed. Yet China cannot hope to create a functioning domestic bond market until interest rates are free.
- Without a discernible yield curve, a host of other financial instruments that could be used to hedge currency risk cannot be launched.

Political Credit. Most importantly, the current system of virtually fixed interest rates tends to perpetuate what is one of the world's worst allocations of credit.

- In this regard, two-thirds of credit resources go to loss-making SOEs that generate only one-third of industrial output.
- The inability of banks to price for risk also prevents loan officers from developing risk assessment skills.
- These weak banking skills impede the flow of funds to more dynamic private sectors.

State vs. Private Banks. Beijing also continues to show favoritism to state run banks over private banks.

- For instance, a plan to allow the establishment of several new private domestic banks has been quietly dropped.
- The pace of opening commerce to private foreign banks has also fallen back.

Slow Progress in Sell-offs. Beijing hopes the AMCs can eventually sell NPLs to foreign or local investors in return for assets in the companies that ran them up. Unfortunately, progress in sell-offs has not been encouraging.

- Legal snags over foreign property rights serve to discourage foreign investors.

- Meanwhile, the longer the AMCs fail to find revenue by selling off SOE assets, the longer the AMCs remain a burden on the central bank.

Bad News: Fiscal Crisis

To make matters worse, China faces an alarming list of future spending demands. These include:

- Standing up a costly welfare/unemployment system to accommodate rural unemployment.
- Creation of an expensive pension system for an aging population (90 million people over 65 by 2003).
- Sharply increasing infrastructure spending that is required for developing the impoverished western part of the country.
- Re-capitalizing state banks that are collapsing because of a mountain of NPLs, that in turn are due to loss making SOEs that continue to suffer from over-production.

In the past, Beijing has tried to use a combination of taxation and government controlled capital markets to finance much of its public spending requirements. But this approach is proving increasingly ineffective.

- Total government debt is now five times what it was in the middle of the 1990s.
- As a result, China is struggling to service its current level of public debt.

Way Out: Bonds. Beijing now realizes that these looming spending demands require a new approach. While the public financial shortfall cited above undoubtedly reflects insufficient tax revenue, Beijing would be ill advised to try to fill the gap with simply higher taxes. That would only worsen the macroeconomic problem of insufficient consumer demand in the economy.

- To reduce the burden on the consumer and minimize price deflation, Beijing must create a liquid bond market that would facilitate the issuance of long-term government debt.
- Beijing should opt for long term interest rates determined in a western style bond market (rather than by the central bank).

- In other words, Beijing should carefully weigh the financial advantages of surrendering government control of capital markets and pursuing true capital market reform based on supply and demand for long-term government debt.

Exploiting the Internet

Chinese access to an open Internet is also a key to Chinese prosperity in a global economy. Jiang Zemin, China's president, can take some pride from Beijing's "Silicon Valley," filled with high tech "whiz kids."

- This catalyst has propelled an explosion of Internet users in China. Subscriptions are up 14-fold to 8.9 million.
- China will soon be the world's biggest market for telecommunications equipment.
- Global IT promises to unleash the full economic potential of China.

Striking a Balance. Beijing leaders need to carefully weigh how to address the Internet in a Chinese social and political context.

- Total Internet freedom maximizes China's long term economic potential.
- But too much Internet freedom could also be destabilizing and threaten Beijing's political authority.
- Perhaps the best approach is for Chinese leaders to strike a balance: Continue to embrace the Internet, but steer it toward an orderly, acceptable combination of economic growth and social stability.

Conclusions

Weighing Options. China stands at the brink. It can either strengthen its economic security. Or it can crash and burn. Which broad economic course of action is appropriate for China? The following are some economic options that China needs to carefully consider:

- The first option would be to strengthen regulatory defenses. But can China remain unscathed, safe behind its self-imposed regulatory barriers? Just as the bricks of the Great Wall were unable to protect the Middle Kingdom from the hordes, so its regulatory and legal walls will not completely save it from global capitalism. Thus, the answer to China's economic

woes must not be to rely merely on such regulatory defenses.

- The second option is neo-Maoism. Should China go back to the days of Mao? Should it revert back to the past economic and political practices, reversing free-market reforms and moving back to a more command-oriented economic model? Frankly, there are leftist forces that think this would be a good idea. But not many.
- The third option is to opt for a "total" free market. In fact, many observers in the West say China must opt for this kind of "shock therapy." These analysts do not seem to understand the following reality: Were it not for the fact that the renminbi is not yet convertible on capital account, China's banking system would have melted down during the Asian economic crisis. It would arguably melt down today as well. This COA would cause China to go the way of Indonesia and Thailand amid a mountain of bad debts and over-leverage, the results of decades of politically driven credit policies.² Thus, the "instant free market conquers all" analysts—who call for full, immediate, unfettered liberalization of the financial markets in China—are ill-advised.

Institutional Reforms. The best economic option for China is to conduct measured economic reforms to strengthen economic security. This option involves increasing and broadening the reforms from within. China needs to improve the internal economic and financial structure. China also needs to become better able to deal with free-market forces. At the same time, China needs to maintain at least some economic defenses until its financial institutions are strong enough to fully withstand the relentless forces of global capitalism. In short, China needs to develop commercial and investment bankers trained and ready for financial battle.

Endnotes

1 NPLs over 20% of total assets place a bank in the alarm zone. Healthy U.S. banks have NPLs that are in the single digit category. The Big Four banks are the Industrial and Commercial Bank of China, the Bank of China, the Agricultural Bank of China, and the China Construction Bank.

CHAPTER 10

INDIA

Introduction. The 9-11 terror attacks on the United States and a global slowdown are shocking India's economy.

- In September India's stocks crashed 20% in a ten day period and reached an eight-year low.
- The already weak industrial sector went into reverse gear. Industrial production fell in one sector after another.
- Exports plummeted and consumer confidence went south.

Growth Slows. Overall, GDP is slowing down sharply.

- Predictions that the economy would grow by 6% this year are dead.
- Even before 9/11, growth was slowing down well below last year's 5.2%. Real GDP rose only 4.4% in the year to 2Q01.
- But growth is in a downturn the rest of 2001 and may even contract in 2002.
- Despite historically-rising trade, imports persist in exceeding exports, thereby draining the economy. (See Figure 10-A.)

Rising Jobless Numbers. The impact of this painful downturn is now being felt up close and personal, as urban Indians lose their jobs and recruitment dries up.

- Every sector has been affected, from banking to steel making.
- Millions are facing voluntary retirement schemes.
- And fewer new recruits are needed.

Idle or Closed Businesses. Many Indian factories are in the throes of a crisis.

- In Rajasthan, ball bearing factories are idle as orders disappear. 11 out of 15 ball bearing factories are without work.
- Two out of five industries are closed or are on the verge of closing.
- At least one-third is set to report a sharp dip in their fortunes.
- About one-third say production and sales are down compared to 2000.
- 40% expect to see a decline in exports.

Figure 10-A. Selected Historical Data

	'97	'98	'99	'00
Gross National Income	357.4	421.3	442.2	479.4
Purchasing Power	1599.0	1665.4	2144.1	2443.2
Real Growth (%)	4.9	5.8	6.8	6
Inflation (%)	7.2	13.2	4.7	4.0
Exports	35.8	33.9	37.1	44.9
To U.S.	7.7	8.7	9.6	11.0
Imports	42.5	43.2	50.1	50.6
From U.S.	3.6	3.5	3.7	3.7
FDI from U.S.	1.7	1.5	1.4	1.3
In U.S.	0.1	0.1	0.1	0.1
Cur Account /GDP %	-1.3	-1.0	-1.0	-0.5
Fiscal Balance /GDP %	-4.8	-5.1	-5.5	-5.1
External Debt /GDP %	23.3	23.5	21.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 10-B

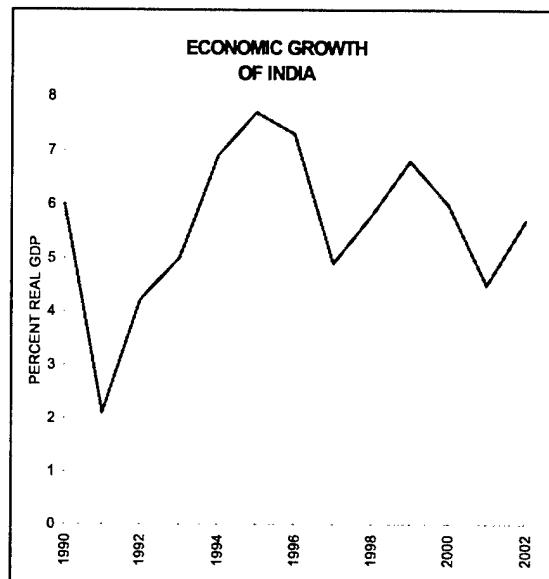
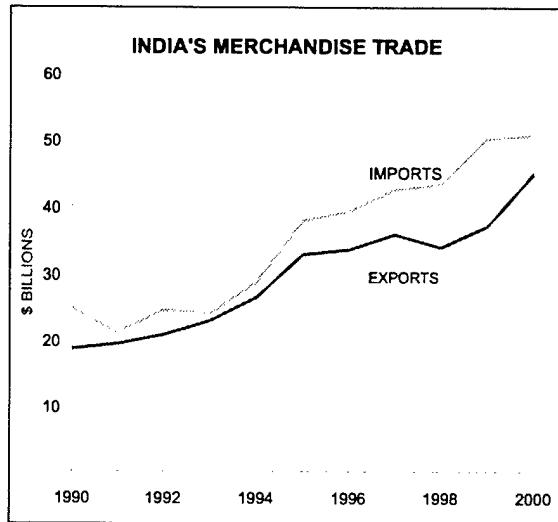


Figure 10-C



Industrial Casualties. Which industries have been hardest hit?

- The once booming automobile, consumer electronics, and consumer durable sectors are reeling.
- Industries like aluminum and steel are also in a precarious situation.

Tourism Drops. In addition, the air-travel and hotel industries have predictably been badly hurt since 9-11.

- The tourism season in India—which peaks between October and March—has ended even before it began. Almost 50% of bookings have been cancelled.
- The average occupancy rate in some leading hotels is currently at 25-30%. This is in sharp contrast to the normal occupancy rate upwards of 65% for this time of year.
- With U.S. Afghan intervention, the industry was virtually closed for the season.

Terror's Information Technology (IT) Toll.

9-11 also accelerated the downward spiral of the star of India's economy, the previously booming IT sector, which accounts for 2% of GDP.

The Rise of IT. Thanks to the big presence in U.S. markets in recent years, the Indian software services sector had seen its exports to the United States boom.

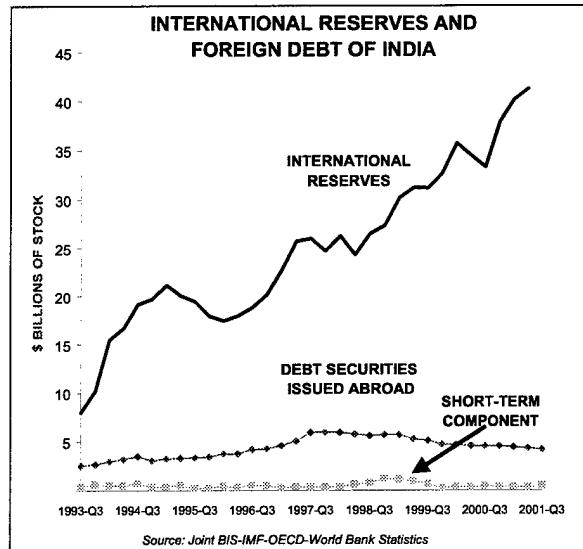
- That in turn played a vital role in driving Indian economic growth.
- IT exports also helped maintain a healthy foreign exchange reserves position, which currently stands in excess of \$40B. (See Figure 10-D.)

Software Scare. Unfortunately, India's software industry is now experiencing a severe slowdown.

- Even before 9/11, U.S. firms started to cut their IT spending.
- Faltering demand for Indian IT products accelerated as the U.S. economy slowed, thus hammering the bottom line of Indian IT firms.

- Software exports used to grow at 50% annually, but are likely to slip to 20% in 2001-2002.
- Demand for software professionals has plummeted. Software recruitment has fallen 30% to 50%. The job market has never been so bad for IT job seekers as it is today. The IT job market shrank by up to 25% in 2001.

Figure 10-D



Good News. That said, the Indian economy is resilient and should be able to recover from the present crisis.

- After all, this is not the first time there has been a conflict in the region. In fact, India itself has been involved in many wars in the recent past.
- The country also has a lot of experience of natural calamities and knows how to deal with destruction.
- In addition, the Indian economy is still fairly inward looking.

Primacy of Agriculture. In this regard, strong domestic sectors—such as agriculture—remain insulated to some extent from the goings on in the rest of the world.

- Agriculture remains the vast heart of the country's economy, encompassing 25% of GDP and about two-thirds of India's population.

- While weak monsoon rains hurt agricultural growth in 1999 and 2000, the rain gods were kinder in 2001.
- Another encouraging sign is the sharp growth in the amount of land used to grow crops. The number of acres of rice, India's most important food grain, has risen by 11% from the same time in 2000.
- As a result, the growth of agricultural production is expected to continue.

Fiscal Crisis. That said, India has daunting problems on the structural side of its economy. In particular, India faces a looming fiscal crisis.

- The combined central and state government fiscal deficit is 9.9% of GDP.
- Given the Maastricht rule of thumb for financial stability—that budget deficits should be below 3% of GDP—India's budget deficit is cause for alarm.
- Worse still, the government shows no real sign of controlling the budget deficit.

Why a Fiscal Threat? The ballooning fiscal deficit puts pressure on long-term interest rates.

- Higher real interest rates choke off long term growth by crowding out private investors.
- Since more than half of central government expenditure is consumed by interest payments, defense, and hand-outs to states, many worthwhile public investments in education, health care, and new infrastructure are crowded out.

Investment Shortfall. New investment is needed now that most of the capacity put in place during the exuberant early 1990s has been used up, and efficiency gains from earlier reforms are running out of steam.

- Unfortunately, the government or private sector lacks the resources to put anything like the \$30B to \$40B a year into infrastructure that India desperately needs for high, sustainable growth.
- In order to generate the accelerated economic growth that in turn could ultimately lift almost 400 million Indians (or 40% of the population) out of poverty,

India needs a second generation of deeper and more comprehensive economic reforms. Is political will there?

Political Buildup. Atal Behari Vajpayee's was reelected as head of a coalition with an ostensible majority—the first sitting Prime Minister returned to power.

- Vajpayee's re-election raised hopes of a new wave of economic reform after the tentative liberalization of the early 1990s.
- Armed with more political clout, Vajpayee finally had a fighting chance to revive India's stalled economic reforms.
- In anticipation of these economic reforms to invigorate the economy, the Indian stock market soared.
- But hopes and high expectations were quickly dashed.

Political Letdown. After an initial burst of passing long-shelved economic measures, there has been almost no forward movement on economic reforms. And with the early momentum lost, Vajpayee faces mounting political criticism from two directions:

- From foreign investors and from his own ranks for not advancing economic reforms aggressively enough.
- From Sonia Gandhi, the Congress leader, who is starting to repudiate the reforms.

Modest Reforms. To be fair to Vajpayee, some economic measures have emerged:

- After seven years of debate, the insurance market was recently opened to private and foreign investors.
- It's getting easier for Indian companies to acquire foreign partners in areas such as pharmaceuticals and mining, as well as to raise capital abroad as foreign exchange restrictions are loosened.
- The government gave up its monopoly on long-distance telephone access and access to the international bandwidth to the Internet—measures that are crucial to the continuing success of India's booming informational technology industry.
- India dismantled the last of its quantitative restrictions on imports.

Unfinished Reform Agenda. But much more must be done. To boost long term economic growth, India must:

- Upgrade its abysmal infrastructure, especially the collapsing and bankrupt power generation system.
- Improve education to reduce the high rate of illiteracy.
- Improve the inefficient legal system.
- Privatize inefficient state-run enterprises.
- Introduce market-linked user charges for public goods and services such as electricity and water.

Toward Policy Goals. These measures would help India reach a number of policy goals:

- Bring down a level of subsidies amounting to about 15% of GDP.
- Reduce the fiscal deficit.
- Enable more spending on primary health, education, and new infrastructure.
- Boost literacy from a low of 62% of 1B population.
- Save the 1.5 million children the World Bank estimates die each year from waterborne disease.

Slow Sell-offs. The government says it intends to reduce the budget deficit by privatizing the loss-making state enterprises.

- Mr. Sinha, India's finance minister, promised to raise 120B rupees (\$2.5B) from privatization in 2001.
- But the government would do well to reach half that figure. The privatization program is falling well below the sell-off target. Fact is, the government has not sold a single company this year. That's not good enough.

McKinsey Report. In a report on India's economy, McKinsey Global Institute underscores the importance of:

- Privatization (cited above),
- Clearing barriers that stifle product development investment, and
- Removing distortions to the property markets.

By taking these three steps, the McKinsey study says India could double its economic growth rate to 10%.

Privatization. Excessive government ownership of Indian industry subtracts 1.4% from India's GDP.

- Almost one-half of India's productive assets are under government control.
- India is probably the most government-controlled of any serious economy in the world.
- India's investment rate is limited to a much lower level than it could be.
- If the government accelerated privatization, India's investment rate would rise from just 24% of GDP to more than 30%.
- For example, India's state-owned electricity companies waste 40% or more of their power, while private distributors lose just 10%.
- Subsidies to these loss-making electricity companies cost 1.5% of GDP—an opportunity cost that could be used for more productive investment elsewhere.

Low Productivity. India's labor productivity is also constrained by loss-making and inefficient state ownership. McKinsey says that India's labor productivity is just:

- 8% of U.S. levels, and 50% of Russia.
- In a dozen "modern" sectors, labor productivity is 15% of the American rate. It is as high as 44% of American levels in software. But it's as low as 1% in electricity distribution.
- McKinsey calculates that labor productivity can double to 8% a year and capital productivity can increase by 50%.

Product Market Barriers. McKinsey says the complex web of regulations and licenses that govern India's products cut as much as 2.3% a year from the country's GDP.

- These barriers include such well-known obstacles as the restrictions on the size of companies making 800 different products.
- India also bans foreign investment in retailing, which keeps consumer prices artificially high and restricts growth.

Property Market Distortions. McKinsey says that land market distortion reduces economic growth by 1.3% a year.

- 90% of India's land titles are under legal dispute. Since potential investors cannot get clear title to land, they do not make long-term investments in that land. Presently, it will take more than 100 years to resolve land titles under dispute.
- This uncertainty severely hinders the incentive for land developers to invest in retail or housing.
- As a result, India has by far the highest property prices in Asia relative to income.
- Just 1% of the workforce is employed in residential construction, compared with 5% or 6% in more developed economies.

Obstacles. Of course, implementing McKinsey recommendations and other economic reforms cited above won't be easy.

- Despite a majority in parliament, the stalled economic reforms of the BJP-led government are still threatened by fractious politics. The politics of economic reform in a democratic country divided by caste, community, and regional identity are often frighteningly intractable.
- In other words, an economic strategy for India does not occur in a social and political vacuum.
- Therefore, the government's ability to take politically painful decisions necessary for more fundamental reforms will likely be hampered by resistance from coalition members wanting to protect their vested interests.
- That translates into a strong political consensus in favor of weak economic reforms and enormous political pressures against strong reforms.

Changing a Mindset. Economic change in India not only involves changing laws and institutions. More importantly, it involves changing the way people think about their attitudes and belief systems.

- There is a strong perception that economic reform loses votes. So the tendency is for

Indian leaders to opt for marginal, incremental change.

- Yet only bold economic reforms will significantly reduce poverty in India anytime soon. Indian Finance Minister Yashwant Sinha supports this position and says, "One has to be ready to take hard (economic) decisions... You pay a much bigger price ultimately for exercising softer options."

Wanted: Clear Message. Vajpayee and his stable of economists must develop and sell a clear message to the Indian people.

- The message: Stronger economic reform is the only way to bring higher growth rates, improve standards of living, and provide the much needed funds for education, health care, and infrastructure.
- Unfortunately, the government has been unable to articulate a clear and persuasive case for structural economic reform.
- Delhi must explain how it could benefit ordinary people and begin to lift 350 million Indian—who live on less than \$1 a day—out of their misery.

Conclusion

9-11 shocked a languid Indian economy. Growth is less than potential, unemployment is rising, and corporations are going out of business. Even the IT sector is reeling. The good news is that India's resilient economy—strong in domestic sectors such as agriculture—should help drive a recovery following the crisis.

The bad news is that the government shows no sign of addressing an alarming budget deficit, which is triggering a fiscal crisis. If India is ever to reduce poverty, it must deepen its economic reforms.

In this regard, the McKinsey study shows how GDP would double if India privatized and removed barriers in product and property markets. Unfortunately, the social and political obstacles to such reforms are formidable.

CHAPTER 11

INDONESIA

Introduction. President Wahid's departure and President Megawati's arrival raises high expectations of better economic performance.

- Megawati has a sensible budget and an economic strategy that would normally establish the foundation for a durable economic recovery.
- Unfortunately, these are not normal times.

Negative Global Setting. The world is moving towards a global recession—or at least a severe downturn. The 9-11 terrorist attacks in the United States:

- Shattered the assumptions of Megawati's economic strategy,
- Stirred up anti-U.S. feelings toward U.S. business interests in Indonesia, and
- Worsened global demand for Indonesian exports, thereby hammering Indonesian growth prospects.

Crisis Management. Given this negative setting, Megawati's best approach is to:

- Lower political expectations of any early economic recovery and
- Limit the damage to the already struggling Indonesian economy.

The Wahid Days

Turnaround. In many ways, Indonesia is still digging itself out from the Asian economic crisis. The country suffered through a deep recession in 1998.

- The economy bottomed out in 1999.
- Under Wahid, GDP finally managed to grow in 2000, though only at a 4.8% clip—hardly enough to make up for the ground lost since 1997.¹
- The 4.8% growth in 2000 was also a far cry from the bounce-back that Indonesia's neighbors enjoyed in 2000.
- At first, a spurt of consumer spending helped to boost growth in 2000.
- In contrast to most other Asian countries, Jakarta found higher oil prices (peaking at about \$35 a barrel in 2000) a godsend for Indonesian exports.²

Figure 11-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	221.5	138.5	119.5	153.3
Purchasing Power	679	568.3	505.0	642.0
Real Growth (%)	4.5	-13.1	0.8	4.8
Inflation (%)	6.2	58	20.7	...
Exports	53.4	48.8	48.7	62.1
To U.S.	9.8	10.0	10.2	11.1
Imports	41.7	27.3	24.0	33.5
From U.S.	4.5	2.3	1.9	2.5
FDI from U.S.	7.4	6.9	10.5	11.6
In U.S.	0.3	0.3	0.2	0.2
Cur Account /GDP %	-2.2	4.2	4.1	5.2
Fiscal Balance /GDP %	0.0	-3.7	-2.3	-4.8
External Debt /GDP %	52.9	120.4	82.7	72.0

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 11-B

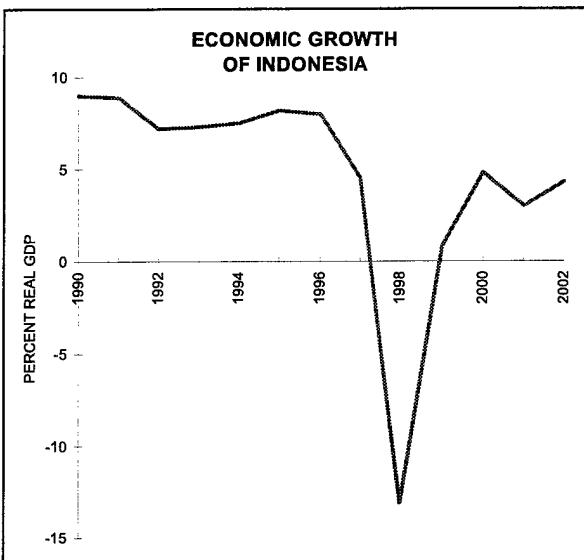


Figure 11-C



Exports Boom. Thankfully, exports remained solid throughout 2000 and were the main driver of economic growth. (See Figure 11-C.)

- In the first nine months of 2000, non-oil exports were up \$10.7B more than in the same period in 1999.
- The weaker rupiah made exports more competitive and boosted the trade surplus.

Growth Not Durable. Unfortunately, the 4.8% economic growth spurt Indonesia enjoyed in 2000 was not sustainable.

- Economic growth in 1Q01 was 2.6%.
- IMF's estimate for 2001 is 3.0%.
- This is much lower than the 7% needed to curb unemployment.

Factors Behind Slowdown. The following factors undermined recovery:

- The U.S. slowdown weakened the U.S. appetite for Indonesian exports.
- Asian regional demand fell.
- Non-oil exports fell.
- The financial windfall from high oil prices—that drove growth in 2000—disappeared. Oil prices fell to \$21 a barrel in 2001.³
- Stocks lost more than 30% of value during the Wahid era. (See Figure 11-D.)
- Wahid showed no knowledge or interest in a coherent economic strategy.

Figure 11-D



- East Timor violence sapped investor confidence, triggering capital flight.
- Foreign investors decided to stay on the sidelines until the dust settles.

Investor Warnings. Foreign investor concerns about the instability deterred the very capital inflows needed to revive investment and finance the government's large fiscal deficit.

- Both Moody's and Standard and Poor's (S&P) credit-rating agencies issued negative warnings about the country's future in early March 2001.
- Jittery investors also saw economic alarm bells. These included:
 - An over-borrowed fiscal situation.
 - High short-term interest rates.
 - A weak rupiah.

Dangerously Over-borrowed. By any realistic financial yardstick, the Indonesian government is dangerously over-borrowed.

- Indonesia's budget deficit is on track to reach a financially unstable 6% of GDP.⁴
- Indonesia's public sector debt is on track to reach a financially unstable 90% of GDP.⁵

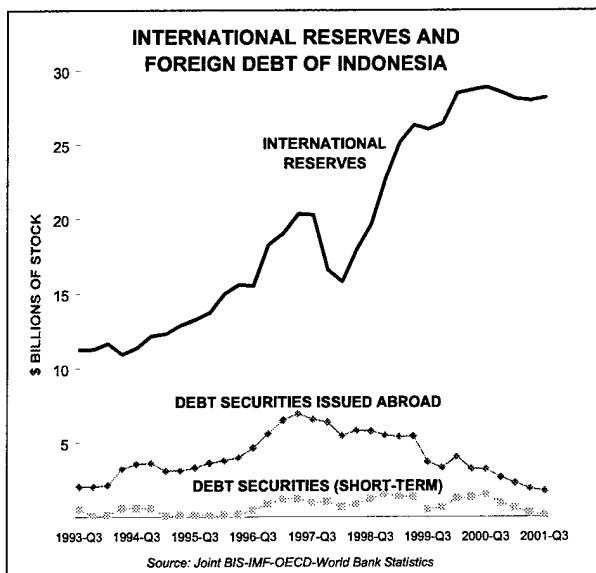
Higher Interest Rates. The over-borrowing also hammered short-term interest rates.

- When the government first forecast a budget deficit in 2001 equivalent to 3.7% of GDP, it was expecting its benchmark one-month interest rate to average 11.5%.
- Before long, a ballooning budget deficit on track to reach 4.8% of GDP pushed short term interest rates to 15.5%—or more than 4% higher than the government forecast.

Painfully Weak Rupiah. Without economic leadership at the top, the rupiah steadily weakened under the chaotic 21-month government of Mr Wahid.

- The rupiah fell from about Rp7,500 to the dollar when Mr Wahid took office to more than Rp11,000 to the dollar when Wahid left office.
- That was the lowest level in 20 months.
- The weak rupiah increased the burden of:
 - Re-paying a huge U.S. dollar denominated foreign debt,
 - Financing the high budget deficit,⁶ and
 - Replenishing foreign reserves.

Figure 11-E



Fear of Default. As a result, S&P said Indonesia risked sovereign default (on government debt).

- IMF asked Jakarta to sharply reduce the budget deficit and heavy public indebtedness.
- On 21 May 2001, S&P downgraded Indonesia's long-term sovereign credit rating from B- to CCC+, putting the country on an embarrassing par with Russia, Pakistan and Ecuador.

IMF Suspends Disbursement. Jakarta's careless economic behavior in the Wahid era antagonized IMF keepers of the purse strings.

- In Dec. 2000, IMF did the unthinkable: cut the cash cow to Indonesia. Wahid failed to get \$400M disbursement from the IMF's \$5B credit line.
- Why did IMF play "tough love" with President Wahid? IMF suspended its funds in December 2000 because President Wahid failed to deliver key banking and corporate restructuring reforms. Two other multilateral bodies, the World Bank and the Asian Development Bank, were already giving Indonesia much less help in 2001.

Other Donors: Wait and See. Indonesia's troubles with IMF poisoned its financial credibility with other donors such as the Paris Club of official creditors.

- The Paris Club had rolled over \$5.8B in debts that Indonesia was due to repay in 2000 and 2001.
- The Consultative Group on Indonesia (CGI)—a group of 30 donor countries that co-ordinates aid from foreign donors—voiced fears over Indonesia's budget deficit in April 2001.

The Megawati Days

Positive Response. Wahid's departure reduced political instability and financial markets reacted positively.

- On 30 July S&P upgraded its credit rating for Indonesia in a vote of confidence for new president Megawati.
- ING Barings advised investors on 16 August to re-enter undervalued markets such as Indonesia.
- The rupiah hit a four-month high on 24 July.⁷
- On 15 August, the Indonesian rupiah reached an 11-month high amid optimism over the new cabinet.
- Since Megawati arrived on 23 July, the currency has surged 30%.
- Similarly, the Jakarta Stock Exchange was nearly 40% higher in July than during its lows in April.

Good Start. Megawati has moved decisively to stop the rot. How? She:

- Installed a top economic team.
- Negotiated a long-awaited deal with the IMF.
- Unveiled a fiscally conservative budget.
- Demonstrated refreshing candor about the daunting economic woes in State of the Union address on 16 August. She highlighted the mountain of debt.
- Megawati also warned of a weak national legal system.⁸

Megawati's Budget. Her new budget correctly attempts to rein in an alarming budget deficit and national debt through painful economic reforms.

- The budget seeks to reduce the deficit from nearly 3.7% of GDP in 2001 to 2.5% of GDP in 2002.

- How? Two ways: Slashing subsidies and selling assets.

Cutting Food Subsidies. A key part of the government's commitments under its IMF-backed reform package is an agreement to cut subsidies in its bloated budgets.

- After years of procrastination, the government has promised to raise politically sensitive energy prices.
- Subsidies on fuel in Indonesia make up more than 30% of the budget, but only the upper and middle classes benefit from the subsidies.
- Nevertheless, Jakarta had to tread carefully with a plan to raise fuel prices by 30% to avoid widespread social unrest.
- Jakarta plans to sell \$66B in assets held by the national bank restructuring agency.

Money from IMF? Yes. Megawati's candid diagnosis and prescription impressed IMF.

- This set the stage for new talks with the IMF in late August 2001.
- IMF ultimately released a \$400M loan disbursement that had been suspended in 2000 as part of a \$9.4B loan program.

Money from Paris Club? Yes. The release of IMF loans also cleared the way for approval from the Paris Club and the CGI, a group of international donors.

- In late September the Paris Club backed the second phase of a two-year debt-rescheduling deal with Indonesia.
- The debt-relief accord paves the way for formal clearance of the second stage of a \$5.8B debt accord struck in April 2000.
- The \$5.8B package covered public debt that Indonesia needed to pay back between April 2000 and March 2002.

Turns on Growth. Whether or not Jakarta can meet IMF and donor goals depends first on whether or not Indonesia manages to generate 5% growth.

- Even before 9-11, this 5% projected growth target for 2002 appeared too rosy.
- Why? Lower growth reflects the gloom surrounding the U.S. and Japanese economies.

Mission Impossible? The tough love camp at IMF may be correct that Indonesia's economic ship of state may no longer be rudderless with Megawati at the helm. But the seas have suddenly become a lot stormier. Now Megawati's goals appear like mission impossible. Why?

Impact of 9-11

Terrorism against the United States is arguably tipping the United States' economy into a full-blown recession.

Weak External Demand. Given this grim external economic reality, it becomes next to impossible for the Indonesian economy to meet the targets outlined by Megawati in her first budget on 7 September. Among those targets were:

- Shrinking the fiscal deficit to just 2.5% of GDP in 2002 from a targeted 3.7% this year and
- Retiring more than \$9B worth of debt.

Assumptions Too Rosy. In addition, economic volatility will put pressure on two other key assumptions that underpin the budget:

- An average exchange rate of 8,500 rupiah to the dollar and
- A benchmark interest rate of 14%.

Impact of Terror Attack on U.S. The terrorist attack on the U.S. has understandably made the assumptions underpinning the budget look unrealistic.

- On September 17, the rupiah closed at 9,340 to the dollar.
- The interest rate is currently running at 17.5%.

Rising Inflation. The weaker rupiah also aggravated Jakarta's struggle to curb inflation.

- In September 2001, the consumer price index was up 13% from a year earlier.
- This spike up is a far cry from the official inflation target for this year, which was 9.3% and 8.00% for 2002.

Stocks Falling. The 9-11 terrorism also caused Indonesian stocks to fall to a 14-month low of 395.

- Since the attacks, it has lost more than 10%, making it cheaper than some of its Asian peers.

Sell-offs Less Likely. Indonesia's plans to step up asset sales and privatization of state-owned enterprises are also less likely now.

- Gathering the necessary political consensus to push through important deals like the continuing sale of 51% of Bank Central Asia will be that much harder as long as the stock market remains depressed.

Threat to Exports. The terrorist attacks will also worsen Indonesian exports already sluggish prior to 9-11.

- A large part of the worry comes from outside the country.
- Though Indonesia is not as dependent on electronics exports as neighboring Malaysia and Singapore, non-oil exports are worth about \$50B a year—more than a third of the country's GDP.
- And more than half of all Indonesian exports go to just three countries, all of which are struggling—Japan, the U.S. and Singapore.

Threats to Business.

- Offshore sales of Indonesian textile & shoe manufacturers may well dip 20%.
- The textile industry—which accounted for 13% of exports last year—is already suffering as orders dry up and goods remain stranded at U.S. ports.
- The Indonesian Textile Association said the sector would fall 20% short of its \$8.2B export target this year.

Conclusion

President Wahid's departure and President Megawati's arrival raises high expectations of better economic performance. Unfortunately, Indonesia's economic problems are daunting. For instance, the country has a mountain of bad debt.

But Megawati has been candid in her economic diagnosis and generally on the mark with her economic prescriptions. She has also formulated a sensible budget and an economic

strategy that would normally establish the foundation for a durable economic recovery.

Unfortunately, these are not normal times. Even if President Megawati makes a heroic effort to implement another impressive blueprint for economic reform, the external economic environment is particularly negative at this time.

The U.S. appetite for Indonesian exports was already weak prior to the 9-11 terror attacks in the U.S. The 9-11 attacks have deepened the U.S. recession and hammered Indonesian exports and prospects for growth.

Given this negative economic setting, Megawati's best approach is to lower expectations of any early recovery and limit the damage to the embattled Indonesian economy.

Endnotes

- 1 Even if Indonesia could sustain growth of 4% a year, it would take until 2005 for it to return to per-capita income levels prior to the Asian economic crisis.
- 2 Every \$1 increase in the per barrel price of oil adds \$100M to \$150M a year to government revenues.
- 3 Oil prices will remain low if the world goes into global recession and the war on terrorism is short. But a more likely scenario, an escalated war on terrorism, will lead to smaller supplies of oil and therefore higher prices.
- 4 A budget deficit over 3% of GDP is financially unstable according to the Maastricht criteria.
- 5 Similarly, a public sector debt of over 60% of GDP is financially unstable according to the same Maastricht criteria.
- 6 Earlier we mentioned the fact that the weaker rupiah was actually helpful to boosting Indonesian exports. But on balance, a weak rupiah hurts Indonesia because its over-borrowed situation outweighs the export benefits it receives from a weak rupiah.
- 7 The Indonesian rupiah reached 9,800 against the dollar compared with more than 11,000 before the vote on 23 July by the 700-seat MPR (People's Consultative Assembly) to replace Mr Wahid.
- 8 The bedrock for any economic transformation is therefore a rule of law and sound institutions. Unfortunately, standing up a stable legal system will take decades.

CHAPTER 12

JAPAN

Introduction. Once again, the economic news in Japan is bad.

- After a decade of economic stagnation, a deflationary spiral appears to be intensifying.
- On 1 February 2002, the Nikkei stock index closed below the U.S. Dow Jones Index for the first time in 45 years.
- Unemployment is at a post-World War II record of 5%.
- Retail sales have fallen for a record five consecutive years.
- Consumer confidence is at a record low.
- The trade surplus is at an 18-year low.
- Long-term growth will remain elusive until Tokyo gets more serious about reform.

Enter Koizumi. New charismatic Prime Minister Koizumi has replaced Prime Minister Mori. So there's hope. Key Questions:

- Can Koizumi lift the world's second largest economy out of its decade long slump?
- Can one man make a difference?

Problems

One thing is certain. The problems are daunting. The problems are twofold in nature:

- First, Japan faces a downward, cyclical problem of weak domestic and external demand.
- Second, Japan faces fundamental weaknesses in its economic foundations. In fact, Japan's essential challenge is a structural one.
- Worst of all, garden variety attempts to solve the cyclical problems tend to frustrate attempts to solve the structural problems.
- Let's turn first to the cyclical problem.

Economy is Worsening. Virtually all economic indicators are negative.

- GDP contracted 0.8% in 2Q 2001.
- The news bolstered fears that Japan may already be in recession.
- The Asian and U.S. recession is hurting the manufacturing sector in Japan.

Figure 12-A. Selected Historical Data

	\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	4812.1	4089.9	4078.9	4677.1	
Purchasing Power	3076.0	2927.9	3042.9	3317.7	
Real Growth (%)	1.9	-1.1	0.8	1.5	
Inflation (%)	1.7	0.7	-0.3	-0.8	
Exports	421.1	388.0	419.2	477.3	
To U.S.	124.3	125.1	134.1	149.5	
Imports	338.6	2812	310.7	377.2	
From U.S.	65.7	57.9	57.7	64.5	
FDI from U.S.	35.6	38.1	49.4	55.6	
In U.S.	125.0	134.3	1553.1	163.2	
Cur Account /GDP %	2.2	3.1	2.4	..	
Fiscal Balance /GDP %	-3.2	-4.5	-6.8	-7.9	
External Debt /GDP %	..	..	..	..

Sources: IMF, World Bank, U.S. Dept of Commerce

Figure 12-B

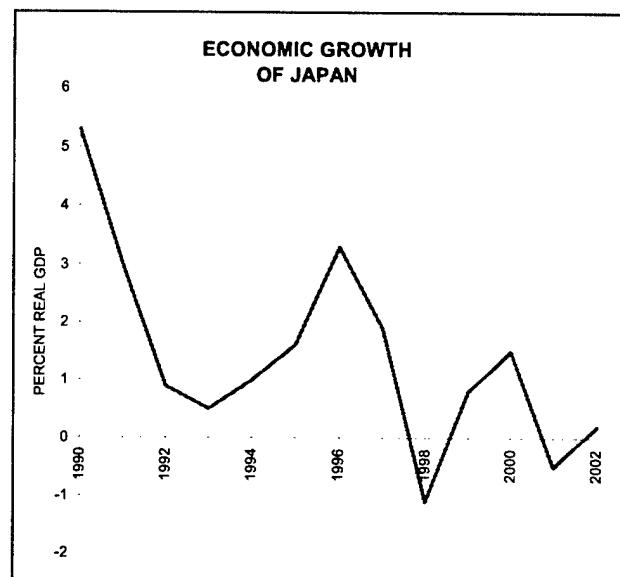
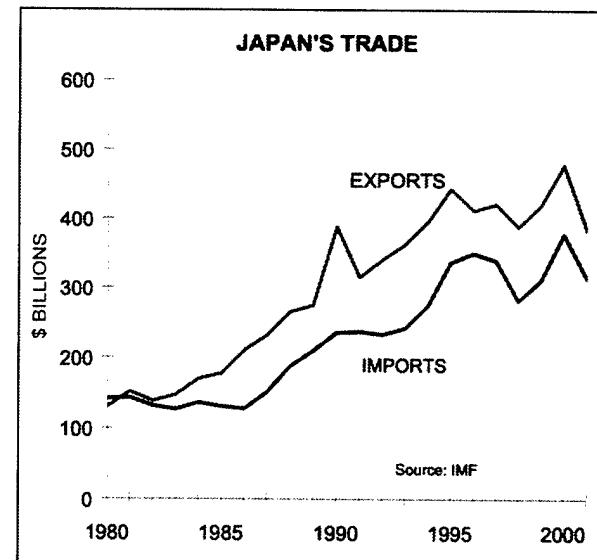


Figure 12-C



- Industrial production fell in August at its fastest annual rate since the 1973.

Grim Legacy. Japan faces an uphill struggle to leave behind the legacy of an asset price bubble that burst more than a decade ago. As Japanese stocks and land prices crashed in the early 1990s,

- Consumers stopped spending,
- Businesses stopped investing, and
- Banks became crippled with bad debt.

Weak Corporate Demand. Corporate demand remains weak. Why?

- Business inventories are at cyclical highs and investment is tumbling.
- Retail sales fell 3.5% in August 2001 year on year, their fifth consecutive month of decline. These weak sales are causing inventories to rise.
- As a result, Japanese companies have been cutting back production.

Weak Consumer Demand. Consumer demand also remains weak. Why?

- Production cutbacks are worsening the jobless rate, now at post-WW2 record 5%.
- This higher unemployment predictably worsens consumer confidence.
- Consumers are afraid of losing their jobs.
- Personal incomes are also falling, thus hurting purchasing power.
- Japanese consumers are also burdened with the highest housing costs, electricity rates and phone charges in the world.
- The result? Consumers are saving for bad times and are not spending.

U.S. Slowdown/Export Woes. The U.S. slowdown can only worsen Japan's stagnation.

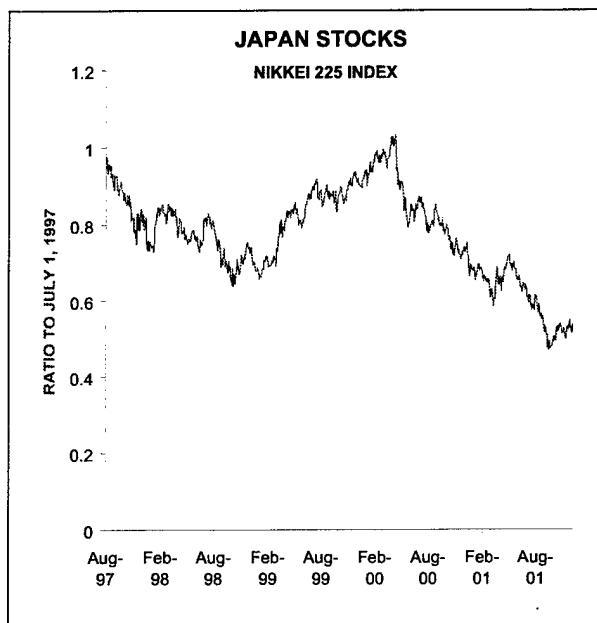
- Japanese exports to the United States are plunging with the U.S. slowdown.
- Japan's trade surplus shrank in September 2001 as exports to the United States had their biggest decline in two years.
- In July, the current account surplus contracted for the eighth straight month.
- In the first half of FY2001, the trade surplus recorded its biggest drop in 23 years.
- The U.S. slowdown will continue to reduce Japanese exports to the United States and

therefore weaken Japanese economic growth.

Stocks Crash. The stock market fell 30% from a peak of 14500 in May 2001. By year's end the Nikkei was at its lowest point in 18 years.

- Industrial production fell in August at its fastest annual rate since the 1973.

Figure 12-D



Banking and Finance

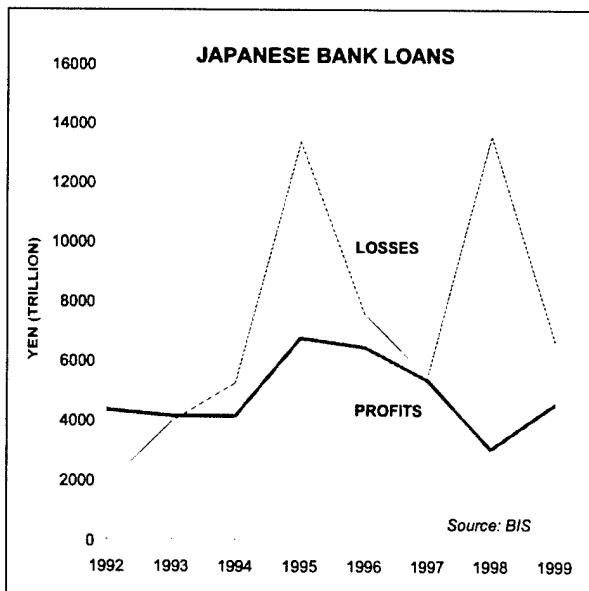
Banking Woes. The falling stock market spells trouble for Japan's embattled banks.

- The banks are wallowing in a sea of losses from bad loans. (See Figure 12-E.)
- The banks are among the biggest holders of collapsing stocks.
- The stock market crash has therefore reduced the Japanese banks' capital.
- As a result, the banks lack the resources to tackle their bad loans by themselves.

Bank Clean-Up? Why doesn't the government just clean up the banks?

- Actually, the government has made sporadic efforts to clean up the banks.
- Tokyo has nationalized a few banks.
- It has injected public funds into the rest.

Figure 12-E



Bad Loans Rising. In other words, this cleanup was left half done—and this is where the danger lies for insolvency.

- While the banks have been slowly writing off their bad loans—making more than Y70,000B of provisions to date—they have been reluctant to push companies into bankruptcy.
- This has meant the bad loan total has kept rising.
- The banks' non-performing loans (NPLs) now total Y32,500B according to the government's figures—a record 7% of all outstanding lending.
- Investors say Tokyo refuses to let the IMF examine the real books because the NPL problem is far worse than the alarming official numbers show.
- The real bank story would send bank stocks south.

Dither. Consequently, Tokyo's financial behavior indicates that it still is not operating a free market financial system.

- In this regard, Japan combines a weak government with a culture that does not allow for corporate or banking failure.
- So instead of biting the bullet of recession and bankruptcy, the Japanese dither.
- Problems are often papered over, not solved.

Moral Hazard. Meanwhile, potential investors in Japanese banks are turned off by what they call moral hazard.

- Government bailouts reward bad behavior.
- Bailouts lock in bad banking habits.
- So reckless loans and over-borrowing continue unabated.

Financial Socialism. Therefore, resolving these financial woes is a Herculean task that involves not just the "clean up" of a few banks.

- What's needed is a fundamental overhaul in the core philosophy that is used to allocate money across the economy.
- The reason is that during most of the past five decades, Japan has not been operating with a "capitalist" system.
- Capital has not been allocated according to free-market forces or a rational sense of price and risk.
- Instead, the banks have tended to lend money to favored companies according to a sense of national duty.
- And almost half of all the financial flows have been channeled through state-controlled organizations, such as the postal savings network.

Reckless Speculation. As the economy reached maturity, the banks made increasingly unwise lending decisions, extending vast loans to reckless real estate projects during the 1980s asset price bubble.

- When the real estate and land market bubble popped, banks were saddled with a mountain of bad loans.
- If Japan had been a truly capitalist country, this might have triggered a spell of "creative destruction."
- Asset prices would have fallen to clearing levels, and under-capitalized banks and over-leveraged borrowers would collapse.
- Capital would then transfer to promising entrepreneurs in greener pastures.
- But the socialist nature of Japanese finance has created a state of suspended rot for an entire decade.
- The financial rot has become progressively worse as the economy has stagnated—and as price deflation gathered pace.

Financial Reform? The Koizumi government claims it is cleaning up this problem.

- Tokyo claims it wants to create a more truly "capitalist" system, in which free market forces—and the capital markets—play a greater role in allocating money.
- But this tortuous process is likely to take up to seven more years before the banks' non-performing loans fall towards international standards.

Policy Assessment. Is Tokyo cleaning up its financial act? The move towards a more "capitalist" economy remains extremely patchy.

Off Starting Blocks. To be fair, free-market forces are taking root in some sectors of the financial system. Why?

- Japan is increasingly part of the global market system.
- Banks are also slowly starting to price their loans to reflect borrower risk.
- Large corporations are raising more finance in capital markets—a trend which means that bank loans have fallen to about 90% of GDP, compared with almost 110% a decade ago.
- Foreigners now own a fifth of all Japanese shares, up from 5% a decade ago, and are exerting greater shareholder pressure.
- Perhaps, most importantly, companies, bureaucrats, and pensioners increasingly realize they have to raise the meager level of investment returns they receive.

Opposition to Change. But for every sign of change, there is also stubborn resistance to change.

- For instance, the vast state-controlled financial institutions have barely reformed—and the proportion of financial flows passing through these state bodies is rising, not falling.
- The private banks still feel compelled to support politically-important companies, such as construction groups.
- And most consumers continue to place their savings in bank deposits or state institutions.

Of Two Minds. Japan's financial world has a schizophrenic feel.

- In this regard, Tokyo faces an extremely difficult task in cleaning up the financial system.
- On the one hand, bankers are under some pressure from the bank's shareholders to behave "rationally" and clean up bad loans to create a profitable bank.
- On the other hand, bankers also know that if they try to cut these bad loans, and make favored borrowers bankrupt, they would face severe opposition from powerful Japanese political and corporate stakeholders.
- Tragically, the Japanese may never manage to square this circle.

Other Structural Challenges. The Japanese economic picture also has numerous other structural problems.

- The old system that created the post-war Japan miracle cannot tackle the problems associated with an aging population.
- Far too much of Japan's public sector spending is directed at inefficient rural, infrastructure projects.
- There is excess capacity in the industrial base.
- Businesses over-invest due to cheap financing by the banks.
- Although the auto and electronic sectors are world-class, too many other sectors are highly protected and uncompetitive.
- Most alarming of all, the pension scheme is ill equipped to meet the funding needs of aging workers.

Solutions

These problems demand drastic solutions:

- Many business sectors, such as construction and retailing, need to be restructured.
- The financial system needs a radical overhaul to allocate capital more effectively.
- Public sector spending has to be redirected.
- Social security and pensions framework needs to be overhauled.

- In short, what Japan needs is a burst of "creative destruction" to remove the swathes of dead wood in the economy.

No Pain, No Gain. However, any attempt to impose these reforms is likely to be painful. Why?

- Reforms would involve a flood of bankruptcies
- Unemployment will soar.
- Economic growth will go down in the short term.

Difficult Transformation. Rhetorically at least, the government is committed to implementing all the necessary structural reforms. However, such reform measures could be unpleasant and politically difficult to implement for two reasons.

- First, Japan is tumbling into a cyclical downturn, and this is before Mr. Koizumi unleashes any serious reforms.
- Second, some government officials claim Japan has already exhausted the obvious macroeconomic policy tools that could offset a domestic contraction.

On the fiscal side they are correct because Tokyo is dangerously over-borrowed. On the monetary side they are ill-advised. Let's turn first to monetary policy.

Monetary Situation. On the surface, the Bank of Japan would appear to have done almost everything it can to stimulate the economy.

- Overnight interest rates are virtually zero.
- The Bank cut the discount rate to an unprecedented low level of 0.1%.

Not Enough. Unfortunately, these low nominal rates are still too high.

- With prices falling from 2% to 3% over the past three years, real interest rates are much higher than nominal rates and still too high.
- That means BOJ must take even more aggressive monetary actions to attack stagnation and deflation.

Fighting Wrong War. Mr. Masaru Hayami, governor of the Bank of Japan, is still reluctant to take more drastic measures to loosen monetary policy.

- On 9 October 2001 Mr. Hayami BOJ rejected the option, claiming it would trigger hyperinflation.
- Mr. Hayami keeps fighting the last war against inflation.
- The economic battlefield has shifted and the new war is against severe price deflation.
- Consumer prices have fallen for 23 straight months!

Recommended Monetary Action. A more promising course of action would be to weaken the yen, restore confidence, relieve the credit crunch, and stimulate its economy.

- BOJ needs to opt for quantitative easing of the money supply. (In layman terms this means to print a lot more yen and inject this cash into the marketplace).
- The best way to do this is to buy up ten-year Japanese Government Bonds (JGBs), which are still flooding the market. That will start to close the gap between actual and potential GDP.
- BOJ also needs to opt for an inflation target between 0% and 2%. This psychological signal would reassure markets that Tokyo was truly committed to attacking the real enemy, which now is deflation.

Failing Fiscal Policy. But if Tokyo needs to loosen its monetary policy even more, it needs to tighten its fiscal policy, notwithstanding the normal drill of easing fiscal policy in a recession. Why?

- Over the last ten years, Tokyo has tried in vain to use fiscal policy to "jump start an over-regulated economy."
- On 16 October Prime Minister Koizumi, like his predecessors, once again announced a supplemental budget to "boost" the economy, this time worth a trillion yen.
- But this seemingly endless string of Keynesian stimulus packages is not working. Why not?
- The day of reckoning for numerous fiscal stimulus packages is finally here. Japan is in the midst of a fiscal crisis.
- If mismanaged, this crisis could potentially turn into a global financial crisis.

Financial Turmoil. To cut to the chase, Japanese public sector debt is now exploding.

- The official public sector debt is currently around 130% of GDP. Japan's debt to GDP is on track to reach 175% of GDP by 2005.
- If unfunded pension liabilities are included, as they should be, the government is already running a public sector debt well above 200% of GDP.
 - The Maastricht criterion for financial stability calls for public sector debt under 60% of GDP.
- The Japanese are running a budget deficit of 6% to 7% of GDP.
 - The Maastricht criterion calls for budget deficits under 3% of GDP.
- In response, Moody's and Standards & Poor's have both downgraded Japan's government debt, correctly arguing that public debt is financially unstable.

Time Bomb. With high and sustained growth unlikely, Japan is on course for ever-rising debt levels relative to GDP.

- And it is a big problem: the largest debt in the world. The debt is larger than that held by the United States or all of Europe.
- There's no chance of stabilizing the debt ratio and even less of bringing it down.
- Exploding debt means higher real interest rates and a tendency—even in Japan—for savings to look for safety and growth offshore.

Social Insecurity. Because of the rapid aging of the Japanese population, the public medical insurance system as well as the public pension system are in big trouble.

- Both may collapse in the near future, unless drastic action is taken.

What's presently preventing financial chaos? Previously, Japan's investors have held Japanese government bonds at virtually no return. They simply roll over the debt when it becomes due at very low interest rates.

- If savers choose to hold and roll over debt, where is the problem? It emerges only when they try to get liquid and opt out with cash.

- What if confidence disappears and Japanese savers want to redeem the bonds for cash and invest overseas for an actual return on their investment? When that happens there's a rendezvous with public sector bankruptcy.
- And if Japan melts down, a world financial crisis is not far off.

Solutions to Fiscal Crisis? Unfortunately, there are no readily available good solutions to this balance sheet disaster. Despite Koizumi's reform instincts, the political dominance of the non-reformist LDP rules out a growth miracle. Other possibilities include massive inflation to wipe out the real value of the debts, heavy taxation or selective repudiation of the debt.

Possible Courses of Action (COAs):

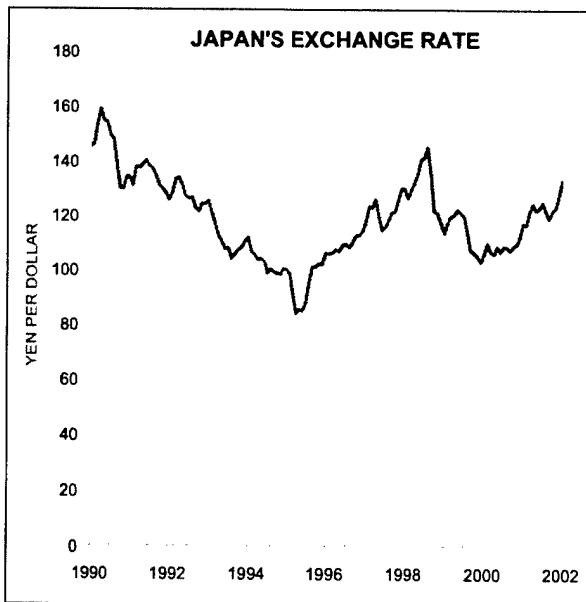
- **Inflation.** Inflating away debt carries grave risks. Households, already old and seriously losing wealth, will save more to make up the loss—and hence precipitate a depression of economic activity.
- **Taxation.** Heavy taxation to achieve a balanced budget was tried a few years ago. It immediately pushed the economy into recession and would do the same this time around.
- **Default.** Debt repudiation does not easily fit the Japanese social model. With its aging population, Japan finds it difficult to reform its entitlement rules.

Is there any other way out of this financial hole?

Yes. Controls. Or as Churchill would say: the worst possible option—except for all the others.

- Tokyo may well require savers to hold and roll over debt. The solution, fully in line with Japanese thinking and practice, is to paper over the problems by returning to repressed finance and capital controls.
- Compared with Japan's troubled experience with open capital markets, capital controls and repressed domestic finance seem low-cost and workable.
- In short, Japan may well opt to close down its capital accounts. If so, this action would end the hope of a world of open, deregulated, and efficient capital.

Figure 12-F



Falling Yen. Meanwhile, the fate of the yen mirrors that of the Japanese economy as a whole.

- After trading in the 115 to 125 yen/dollar range for most of 2001, the yen fell by 7% in December 2001, to 132 yen, the lowest level in three years.
- Is a falling yen good or bad for the Japanese economy?
- It's a mixed bag:

Positive Impact. On the one hand, a weaker yen offers some hope to lift the economy. A weaker yen makes:

- Japanese exports more attractive.
- Raises import prices, thus curbing Japan's serious problem of price deflation.
- As price deflation subsides, real interest rates drop, which acts as a de facto monetary policy stimulus.
- In this sense, a weaker yen is a necessary condition for a sustained Japanese recovery.

Negative Impact. But the political and economic risks of further depreciation may well outweigh the benefits.

- In particular, the speed of the yen's deterioration has alarmed its neighbors as well as Washington.
- A free falling yen is bad.

- In December 2001, Beijing, Kuala Lumpur and Seoul told Tokyo that they view a weak yen as a direct threat to their exports.
- The Chinese and South Koreans have warned Tokyo that a sharp fall of the yen risks tit-for-tat devaluations in the region, thus triggering financial instability throughout a region still recovering from the 1997 financial crisis.
- Similarly, negative diplomatic reactions could trigger rising trade protectionism in the region.
- The weak yen also risks exporting deflation to a global economy far more vulnerable than it was prior to 9-11.
- In addition, there's the danger that the private sector will become more risk-adverse:
 - For instance, if foreign investors become convinced the yen was in permanent decline they would pull more funds out of the already depressed stock market.
 - Such sustained capital flight would push up interest rates, further damaging indebted Japanese companies and their creditor banks.
- The danger of a spillover effect on other Asian countries is then very large.

Conclusion

Since the Japanese economy is the foundation for Japan's national security strategy, the USG is vitally interested in Tokyo's ability to dig itself out of their ten-year slump and financially unstable condition. After a decade of economic stagnation, Japan's new Prime Minister Koizumi enters 2002 focused on an economy lurching from recession to near depression. In essence, the Japanese economic problems are twofold: both cyclical and structural in nature.

Obviously the U.S. downturn and the events of 9-11 have only served to worsen the weak economic performance in Japan as well as the rest of Asia. On the structural side, a chief concern is the socialist banking sector that is weighed down with bad loans and that recklessly misallocates capital.

While there are promising efforts to move away from financial socialism, not enough is being

done to implement a free market banking system. Given the severe price deflation in Japan, real interest rates are still too high for a country in a prolonged slump.

In addition, the Japanese government debt—at 130% of GDP and rising fast—is dangerously high. Japan would be in a much stronger position to work with the United States to assume an expanded military role in Asia if its mountains of bad loans and government debt did not weigh it down.

Finally, Tokyo needs to orchestrate an orderly fall in the yen, which helps lift the economy via stronger exports and imported inflation to offset. But Tokyo must avoid a free-falling yen that would raise political and economic risks, thus outweighing the benefits cited above.

CHAPTER 13 LAOS

Introduction. A quarter century after independence, Laos is the second poorest country (after Cambodia) in East Asia with a GNP per capita of about \$330.

- Laos remains one of the few remaining communist economies in the world and one of the poorest nations on Earth.
- For most of the 5M people, simple subsistence is the norm.
- The average income is less than \$1 a day.

Structural Woes. Laos faces a number of structural economic difficulties.

- Laos is a landlocked country with a primitive infrastructure.
- Laos has no railroads, a rudimentary road system, and limited external and internal telecommunications.
- Electricity is available in a few urban areas.
- Laos has a small industrial base and depends heavily on subsistence agriculture, which accounts for half of GDP and 80% of total employment.

Low De Facto GDP. To make a dent in widespread poverty, Laos must boost GDP close to 8% a year.

- Even the inflated official GDP figures of 6%, or more, fall short of the mark.
- More reliable private economists put the figure at closer to 2%-3%.
- Most of this growth comes from aid-induced growth in the construction sector.

Foreign Economic Relations

No Confidence. Economic indicators reflect low confidence in the Laotian economy.

- **Foreign Direct Investment (FDI) Plummets.** Most foreign investors (especially the Thai) have pulled out of Laos. Direct foreign investment approvals have declined from a peak of \$2.6B in 1995 to just \$20M last year.
- **Weak Trade.** Imports, mainly of consumer goods from Thailand, stood at \$540M in 2000, while exports were only \$323M.

Figure 13-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	1.9	..	1.4	1.7
Purchasing Power	6.0	6.6	8.8	8.3
Real Growth (%)	6.5	4	5	5.7
Inflation (%)	19.3	87.4	134	27.1
Exports	0.3	0.3	0.3	0.3
To U.S.	0.015	0.022	0.014	0.010
Imports	0.6	0.6	0.6	0.4
From U.S.	0.003	0.004	0.001	0.004
FDI from U.S.	-0.004	-0.006	-0.007	-0.009
In U.S.				
Cur Account /GDP %	-16.1	-10	-11.2	-5.8
Fiscal Balance /GDP %	1.7	2.4	-7.7	-6.2
External Debt /GDP %	136.1	199.1	181.4	

Sources: IMF, ADB, World Bank, U.S. Commerce

- **Currency Collapse.** The Lao currency, the kip, has plummeted to nearly 10,000 to the U.S. dollar from 7,900 in 2000, 4,250 in 1998 and 935 in 1996. Of the Southeast Asian currencies, only the Burmese kyat lost more in value over the same period.

Hooked on Foreign Aid. The government has become totally dependent on foreign aid.

- Foreign aid finances public investment.
- Foreign aid also covers the severe current-account deficit in its balance of payments.
- In 1985-86, before the first tentative market reforms were introduced, foreign assistance accounted for 6.25% of Laos' meager GDP.
- By 1988, it had increased to 10%.
- Now it is more than 16%—a level at which self-sufficiency will be difficult to achieve.

Failure of Foreign Aid. This trend toward increasing dependence on foreign assistance is not unique to Laos. In fact, Laos fits a disturbing pattern of failing economic development programs worldwide.

- Poverty reduction—in the form of several decades of huge disbursements of development aid—simply hasn't worked, according to Vientiane-based German economist, Hans Luther.
- The number of countries with a per-capita income of less than \$900 a year has risen to 49 today from 25 in 1971, and none have managed to rise out of the category in the past decade.

New IMF Plan. In April 2001, the International Monetary Fund approved in principle a three-

year arrangement for 31.7M Special Drawing Rights (\$40.7M) to lift Laos out of poverty.

- Part of the plan is to restructure Laos' deeply insolvent state banks, to increase revenue collection to fund development projects, and to promote the private sector.

Early Optimism. Things were not always this bleak. In fact, back in the early 1990s, there was reason for cautious optimism.

- Laos is building up a textile industry.
- There was also hope for an expansion in energy exports from a string of planned hydroelectric plants.

Promising IMF Plan. In addition, Laos embarked upon promising IMF-sponsored economic reforms in 1989.

- These included an overhaul of the tax system, a two tier-banking system, lower tariffs, and privatization.
- Under the economic reforms of the New Economic Mechanism (NEM) in 1992, Laos made good progress towards a market economy.
- The economic reforms supported macroeconomic stability, and increased trade and investment flows.

Economic Progress. Thanks to the NEM's economic reforms, Laos demonstrated economic progress, at least for awhile.

- Laotian GDP growth averaged 7% for eight years.
- Inflation was also kept low.
- Since then, the Laotian economy has become mired in a dismal economic situation from which there seems to be no escape.

Reform Slows. Why the economic reversal? The momentum of economic reform in Laos had been flagging since 1997.

- Serious economic mismanagement, corruption, excessive government spending, and a huge trade deficit have recently plagued the economy.
- In particular, weak macroeconomic management was compounded by indecisive economic decision-making.

- This made it more difficult to react to the deteriorating macroeconomic situation.
- An inadequate regulatory framework, weak financial management, and high non-performing loans undermined banking.

Asian Economic Crisis

When several Asian economies crashed in 1997, many observers thought that Laos—with its small, mainly agricultural economy—would be shielded from the worst effects of the crisis. Wrong.

- Because Laos depends heavily on its economic relationship with Thailand, it was damaged when the Asian financial crisis that hit Thailand in July of 1997.
- Thailand, the biggest investor in Laos, was the first to pull out of Laos when the crisis hit their own country.

Vulnerability. The economic vulnerability of Laos to external shocks began to mount prior to the Asian economic crisis.

- The over-reliance of Laos on the Asian region for export markets, large savings, and trade receipts made it vulnerable to an Asian downturn in the region.

Impact of Asian Crisis. In the wake of the Asian economic crisis:

- FDI commitments to Laos fell by 91% and actual FDI flows declined by 41%.
- The Lao kip—closely linked to the Thai baht—was particularly vulnerable to exchange rate volatility that rocked the region. As a result, the kip lost 70% of its value vis-à-vis the US dollar between July 1997 and June 1998.
- Inflation also began to rise—and the social impact was significant. Inflation weakened economic confidence, which triggered an outflow of funds from the banking system.

Mitigating Factors. A number of factors mitigated the impact on the Laotian economy.

- Laos was insulated from the sharp credit crunches and rapid flight of portfolio investment (e.g. stocks and bonds).
- They were not integrated into the global financial markets and had received virtually no volatile, short-term capital inflows.

Growth Slows in 1998. These mitigating factors as well as favorable weather conditions (that led to a strong agricultural performance) helped Laos initially maintain robust growth of nearly 7% in 1997. But 1998 was a different story. Growth slowed to 4% in 1998.

Macroeconomic Mistakes. This economic slowdown reflects a number of serious macroeconomic mistakes Vientiane made in response to the Asian economic crisis.

- Vientiane unwisely pursued loose monetary and fiscal policies that multiplied the negative effects of the crisis on domestic macroeconomic stability.
- Vientiane's focus on food self-sufficiency led to extra-budgetary expenditures through rapid monetary expansion.
- Revenues fell short, resulting in a fiscal deficit in 1996/97 whose share of GDP was 1.5% higher than expected.
- Negative real interest rates, high inflation, and expectations of devaluation eroded investor confidence and accelerated the flight out of the kip.

Solutions

The Challenge. Regaining economic and financial stability is an immediate priority.

- Decisive action is needed to tighten monetary and fiscal policy.
- That will help stabilize the exchange rate and dampen inflationary pressures.
- A broad financial sector restructuring program is needed to improve the banks' ability to intermediate resources effectively.
- Laos will need to improve the climate for investment in order to restore external investment flows and boost exports.
- The depth and speed of the reform efforts of Laos cannot be underscored enough.
- Strong institutional capacity, good governance, and sound economic management will be critical for Laos.

Two Saving Graces. After 6.5% growth in 1997, the economy maintained a growth rate of 4% or more from 1998 through 2000.

- If the economy has so many problems, what's keeping the economy afloat?

1. "Gifts from Heaven." For now, many Lao rely on remittances from overseas.

- In 1975, some 350,000 Lao, almost 10% of the population at the time, left the country after the Communists took power.
- In a recent survey, 56.5% of the population in Vientiane said they had relatives overseas and 48.1% of respondents said they received money from them.
- A State Planning Committee report lists "remittances from abroad" as the single most important source of income in the Vientiane valley, representing 28% of household earnings, in contrast to 25% from agriculture, 22% from wages, and 18% from business.

Unfortunately, these remittances are more likely to strengthen Laos' new role as an economic basket case than to lead to the kind of sustainable development that Laos needs to fight poverty effectively.

2. Donor Aid. For the foreseeable future, the economy will depend on aid from the IMF and other International Funding Institutions (IFIs).

- Foreign aid, mainly from Japan, Australia, and Sweden, covers trade and fiscal deficits.
- Aid provides 80% of the capital budget.
- But this international funding stopgap won't last forever.
- International donors from Japan, Sweden, and Australia are increasing the pressure for progress on reforms before making new disbursements, which already account for more than 16% of the country's GDP.

Economics/Security Link. Given this negative socioeconomic environment, it's not surprisingly that "the natives are restless."

- Popular pressure for economic and political change is growing and a protracted rebellion has erupted in the north.

The Political Economy. How is the government battling economic stagnation and the revived threat of Hmong insurgency?

- It attempted to attract foreign tourists—and the foreign currency they bring—by declaring 2000 "Visit Laos Year," that looked promising at the start. But a spate of bombings at bus stations, restaurants, and hotels killed the campaign.
- In essence, the Communist leadership "wants its cake and eat it too."
- The Laotian government remains dependent on Western foreign aid for its macroeconomic survival. It looks for creative ways to fend off sanctions and cajole the West into still more economic carrots.
- Unfortunately, it shows no sign of pursuing serious market-oriented economic reform, despite signs that this impoverished nation could be entering the early phases of economic and political instability.
- In fact, Vientiane's Communist rulers—fearful of a threat to their rule—are turning back to their old fraternal communist parties in Vietnam and China.

Chinese Objectives. Closer relations track with China's larger diplomatic game of:

- Counterbalancing the U.S. and Japanese influence in the region and
- Providing China with a useful gateway for exporting cheap goods from Yunnan province into Southeast Asia.
- And unlike the Western pressure on Vientiane to become more market-oriented and democratic, Beijing supports the status quo in Laos because Beijing is also trying to fend off pressure on itself to open up.

Chinese Carrots. Toward these ends, Beijing is using the opposite strategy from the West. It's using economic carrots (instead of sticks) to grease the skids with its Communist partner:

- Beijing has recently boosted both economic and military assistance to Vientiane.
- In celebration of the 25th anniversary of the Communist takeover in Laos, Beijing donated \$7.2M to help build a mammoth Laotian cultural center.
- Vientiane also reportedly accepted interest-free foreign currency loans from Beijing to stabilize the embattled Laotian currency.

Conclusion

USG Policy. USG policy is awkwardly stuck in a "halfway house."

- Longstanding Western aid continues to prop up a communist leadership that opposes market reform anytime soon.
- Yet the World Bank (and others) has tied future economic assistance to economic and political reforms, which so far are going nowhere, or in a cosmetic direction at best.
- Similarly, economic and political relations have soured with USG, which continues to withhold normal trade relations.
- Meanwhile, Laotian Prince Souivong—who is in exile in France—is leading a growing international chorus to "negotiate a transition" to a market-oriented democracy.

Strategic Questions to Ponder. Given the fact that we have seen little or no effort in Vientiane to pursue market reforms or open up politically, maybe we need to rethink U.S. policy toward Laos:

- Is international (Western) pressure on Laos proving counter-productive to achieving further economic reforms?
- Under such duress, will Laos come to rely more on China and Vietnam?
- In short, how can we best shape economic and political change in Laos?

Recommendation. The USG should develop creative new ways to promote a market-oriented democracy in Laos.

Final Thoughts. Laos remains one of the poorest nations in the world. After eight years of reforms and economic progress, reforms slowed in 1996. Internal economic mismanagement and the Asian economic crisis caused the economy to deteriorate. The currency collapsed, FDI fell, and inflation soared. Only remittances and donor support keep this economy afloat.

While China uses economic carrots to support the status quo in Vientiane, Western economic sticks are proving ineffective. Vientiane shows no sign of pursuing serious economic or political change. Perhaps it's time for us to take a new swing at Western policy.

CHAPTER 14 MALAYSIA

Introduction. The Malaysian economy is rapidly slowing down and may already be in a recession.

- After about a robust 8.3% GDP growth in 2000, GDP grew at about 1% in 2001.
- Given the U.S. downturn and the anti-U.S. terrorism on 11 September, the future growth numbers will almost certainly be worse than the early IMF forecasts that expected a rebound in 2002.

Rising Jobless Numbers. Socially, a painful Malaysian recession is already here.

- The evaporation of the U.S. appetite for imports translates into a sharp downturn in Malaysia's manufactured exports.
- As a result, more than 30,000 people were laid off between January 2001 and September 2001.
- Most the lay-offs are from factories producing electronics products.
- And things will get worse.
- By the end of the year, the government expects more than 390,000 people to be out of work.
- That would mean unemployment is rising from 3.1% in 2000 to 3.9% for 2001.

Confidence Problem. In essence, Malaysians have a confidence problem and are concerned about their economic future.

- Almost 60% of respondents surveyed in September 2001 feel it will be difficult to get a job—the lowest level since the survey began after the Asian Crisis in 1997.
- Even those who are clinging to their job are fearful of losing their job.
- And that means people are reluctant to spend money.

Fiscal Stimulus. In essence, therefore, Malaysia's businesses and consumers have lost the ability or confidence to spend money.

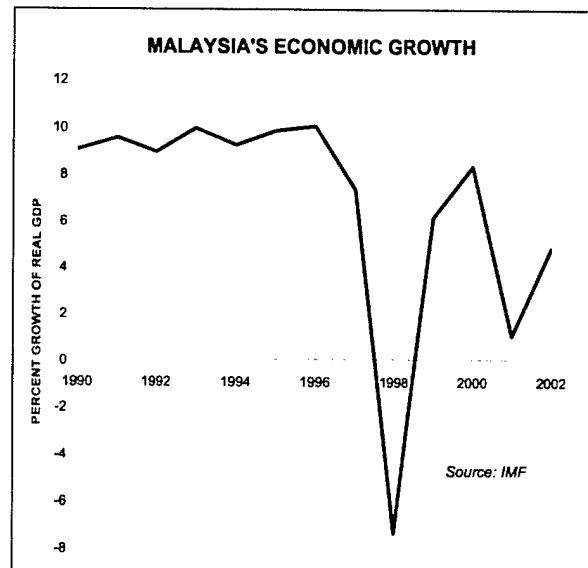
- In response, Prime Minister (and Finance Minister) Mahathir has decided to fight off recession with the Keynesian medicine of more government spending.

Figure 14-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	98.2	79.8	77.3	89.3
Purchasing Power	168.0	155.0	180.8	212.4
Real Growth (%)	7.3	-7.4	6.1	8.3
Inflation (%)	2.6	5.1	2.8	1.5
Exports	78.5	73.0	84.6	98.2
To U.S.	18.5	19.5	21.8	26.0
Imports	78.5	58.1	65.4	82.2
From U.S.	10.8	9.0	8.8	10.8
FDI from U.S.	5.6	6.2	5.8	6.0
In U.S.	0.3	0.2	0.1	0.0
Cur Account /GDP %	-5.2	13.5	15.9	9.4
Fiscal Balance /GDP %	2.4	-1.8	-3.2	-5.8
External Debt /GDP %	42.1	52.7	45.0	39.8

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 14-B



- So in October 2001 Mahathir announced a further round of pump priming.
- A further 4.3B ringgit (\$1.1B) will be spent by the government on infrastructure works, in addition to the 3B ringgit spending program announced by Mahathir in March.
- On 21 October, Mahathir increased Malaysia's budget expenditure for 2002 by 10% to just over 100B ringgit.
- Mahathir has also:
 - Cut income taxes
 - Slashed import duties and
 - Handed out bonuses and a 10% salary hike to 800,000 civil servants.

Looser Monetary Policy. Monetary policy has also been eased in hopes of stimulating growth.

- Interest rates are at their lowest in a decade.
- The base-lending rate is now just 6.2%.

Fiscal Elbow Room. Some might argue that Malaysia's budget deficit—at 5% of GDP—is far above the Maastricht criterion for financial stability (budget deficits at no higher than 3% of GDP).

- In normal times this is true. But these are not normal times.
- The global downturn and the 9-11 anti-U.S. terrorism have devastated global demand for most Malaysian exports.
- Equally important, Malaysia has a low national debt—only 40% of GDP.
- This figure is well under the Maastricht criterion for financial stability—a national debt that is below 60% of GDP.
- In short, Malaysia has lots of fiscal elbow room to press the Keynesian button to inject more short-term demand into the economy.
- Mahathir therefore hopes loose fiscal and monetary policies will start to close the gap between potential GDP and actual GDP.

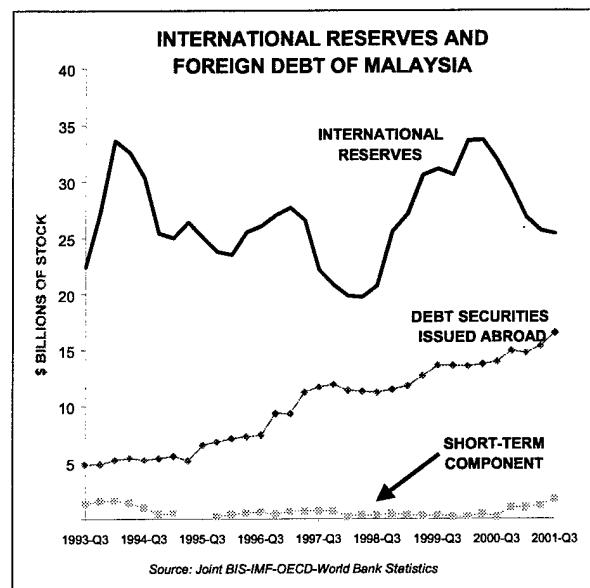
Falling Currency Reserves. Another area of concern for Malaysia has been the state of its currency reserves. (See Figure 14-B.)

- On 15 May the currency reserves fell for the 13th straight month—reaching a 29-month low of \$26.1B.
- That was a 13% fall from their peak of \$30B in September 2000.
- This sharp fall in the currency reserves is often a good indicator of capital flight. When an economy gets shaky, we often see capital flight as investors bail out of the local currency and buy U.S. dollars.
- While these negative indicators are not yet compelling or reason for alarm—since Malaysia still had over 3 months of import cover—there was initially some cause for concern since trends were moving in the wrong direction.

Currency Reserves Stabilize in 3Q01. But since June 2001 the Malaysian currency reserve situation has stabilized—and even improved a bit.

- The reserves have actually registered a net increase.
- Currency reserves have risen by RM1.2B or 1.1% to RM106.5B at mid-September from RM105.3B two weeks earlier.
- Why the improvement in currency reserves?
- Up through most of 3Q01, Malaysia's balance of payments benefited from an economy that is more broad-based than Singapore and other Asian states.
- Petroleum, gas and palm oil all contribute significant export earnings.
- And in an ironic twist to the global tale of woe, exports of sterile rubber gloves, of which Malaysia is the world's largest producer, have been boosted by almost 50% as a result of the global anthrax scare.

Figure 14-C



Export Downturn Likely. That said, the trade performance of Malaysia is taking a hit.

- The 9-11 terrorist attacks in the United States have sharply illustrated Malaysia's dependence on external flows of trade and capital, albeit not as much as Singapore.
- Palm-oil stockpiles have begun rising because of a reluctance by shippers to go anywhere near Pakistan—one of Malaysia's big markets.

- War risks amid a slowing global economy are putting downward pressure on palm-oil prices.
- Meanwhile, revenues from tourism, the country's second-largest foreign-exchange earner after palm oil, have fallen by 30% since mid-September.
- Against such a backdrop, there is little the government can do apart from making sure the fundamentals are right to capitalize on a global recovery.
- Are the fundamentals right?
- To address this question, let's assess the foreign exchange rate regime, and the foreign investment climate.

Overvalued Ringgit? Unlike most of the other ASEAN states, Malaysia has maintained its fixed exchange rate regime. How will the regime fare in the future?

- U.S slowdown means weaker demand for Malaysian exports, which in turn means weaker demand for the ringgit.
- That means the pegged ringgit has not kept up with the depreciation of other Asian currencies and is arguably overvalued against the U.S. dollar today.
- If Mahathir floated the ringgit, it would fall.
- Malaysian domestic investors want to sell ringgit and buy dollars before the unattractive specter of a ringgit devaluation becomes a grim reality.

Falling Foreign Investment. Negative foreign investor perceptions of the Malaysian economy also hurts Malaysian interests.

- Since Malaysia became independent in 1957, Foreign Direct Investment (FDI) has been the largest factor fuelling growth.
- Globalization has been good for Malaysia, with foreign capital funding many of its ambitious infrastructure projects.
- But this foreign investment appears to be drying up.
- For instance, foreign investors' holdings of Malaysia's share market have dwindled to about 3% from almost 30% in early 1997.
- The short-term component of Malaysia's foreign debt is quite small. (See Figure 14-B.) In comparison to foreign participation rates seen in other countries,

there appears to be an abnormal fear by foreign investors of short-term investments in Malaysia.

Why Short-term Investors Foreign Investors Stay Away. Short-term investors are largely taking a "wait and see" attitude, indicating that Malaysia needs to do more to address its structural economic reforms necessary for long-run sustainable growth.

- Investors would welcome a more consistent and foreign investor-friendly policy environment.
- How effectively Malaysia addresses the following four investor concerns are likely to have a significant bearing on the extent to which private capital flows into Malaysia are restored, which in turn will help define growth patterns in the future.

1. **Government Involvement in Economy.**

Investors concede that Malaysia's interventionist measures, such as capital and currency controls, insulated the economy and contributed to economic growth the past two years.

- However, they would like to see the government focus more on promoting those structural and private sector reforms necessary in developing and strengthening market-oriented institutions and policies.
- Investors also express concern about the prevalent link between business and government and the resulting conflict of interest.
- They note that more consistent policies as well as incentives for foreign investment would help to restore investor confidence.

2. Application of the Law. While investors agree that Malaysia's legal framework is adequate, they are very concerned about what they perceive to be inconsistent application of the law, particularly in civil cases.

- In addition to questioning the independence of the judiciary, investors express concern about the treatment of foreign investors under the Malaysian legal system.

3. The Banking System. Investors share several concerns regarding Malaysia's banking system:

- Investors would like to see bank restructuring completed—especially the bank consolidation process.
- Investors would also welcome a more consistent and minimal government role in the banking system.
- Other concerns include the lack of Central Bank independence.
- Investors concede that government agencies have eased the debt burdens of domestic corporations and banks generally have returned to profitability.
- But they are concerned about the level of non-performing loans.¹
- About 30% of these restructured debts will need to be rescheduled unless genuine corporate restructuring begins with Malaysia's politically connected corporations.

4. Conflicts of Interest. Investors perceive conflict of interest as a major problem in Malaysia.

- They point out that business and political linkages foster crony capitalism, influence of vested interests, and political patronage.
- They also are concerned about how this will affect Malaysia's long-term competitiveness and growth.
- In this regard, it's important to note that Malaysia's competitiveness is faltering. The World Economic Forum's ranking of Malaysian competitiveness has slipped from 16th to 25th.

Conclusions

The U.S. appetite for Malaysian manufactured exports has fallen. Malaysia's economy is rapidly slowing down and may already be in recession. Unemployment is going up and consumer and business confidence is going down.

In response, the government has opted for lower interest rates and more government spending in hopes of stimulating economic growth. Fortunately, the government has

ample fiscal elbow room to boost government spending.

To sustain strong growth, the country must attract more foreign investment. That won't happen unless Malaysia creates a more attractive business climate for foreign investors.

Investors are holding back until their concerns in the following four areas are addressed:

- Too much government involvement in the economy,
- Ineffective application of the law,
- A socialistic banking system, and
- Conflicts of interest.

Endnotes

1 The government says NPLs are 7% of total assets. Private estimates are much higher.

CHAPTER 15 MALDIVES

Introduction. The Maldives economy is a mixed bag. Tourism and fishing are sluggish, but government is seeking structural reforms.

Slowdown. The economy is slowing down.

- Back in the 1995-1999 time period, the Maldives enjoyed an annual average growth rate of 8.2%.
- The economy slowed down to 6% in 2000.
- The slowdown in the global economy in 2001 is worsening the overall slowdown in the Maldives' economy.
- High oil prices since early 1999 have also dampened economic growth.

Factors Behind Slowdown. At home, the slowdown is largely due to under-performance in two key sectors: fisheries and tourism.

- The total fish catch has declined by about 17% since last year.
- While tourist arrivals are up 8.7%, this trend is more than offset by a glut of empty rooms after the opening of 13 resorts.
- These economic setbacks make it difficult to accommodate the 5,000 new graduates joining the labor force each year.

Good News.

- Exports increased by 13.2% in 2000, largely due to the high export value of fish products despite a smaller fish catch. Imports decreased by 1.0% because of the economic slowdown. As a result, the trade deficit fell from 67.6% of GDP in 1999 to 53.3% in 2000.
- The current account improved as a result of an increase in foreign grants and loans.
- Fortunately, short-term debt is almost non-existent. A low debt service ratio of 3.9% in 1999 was maintained in 2000.
- Inflation is low, as prices of food and other commodities declined relative to 1999.

More Good News. The government is addressing structural reforms by close work with the Asian Development Bank (ADB).

- Improvements are sought in the post-secondary education system, power supplies, public accounting systems, legal

Figure 15-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	322.3	0.322	0.435	
Purchasing Power	500.0	3.545	1.443	
Real Growth (%)	11.2	7.9	8.5	5.6
Inflation (%)	7.6	-1.4	3	-1.1
Exports	0.093	0.096	0.092	0.109
To U.S.	0.021	0.037	0.058	0.096
Imports	0.307	0.312	0.354	0.342
From U.S.	0.006	0.005	0.008	0.006
FDI from U.S.	..	..	..	..
In U.S.	..	..	..	..
Cur Account /GDP %	-6.8	-4.2	-11.1	-4.6
Fiscal Balance /GDP %	-1.4	-1.9	-6.7	-7.7
External Debt /GDP %	59.7	62.5	67.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

and judicial training, customs offices, and science and technology applications.

- Unlike many island governments, it is building a national accounting database.

Unfinished Agenda. That said, the unfinished agenda is daunting. On the structural front, the Maldives needs to strengthen its economic foundation in at least five acute areas:

- Regional Development—to build basic social and economic infrastructure for a more equitable and cost-effective distribution of social and economic services.
- Environmental Management—to protect the environment through institutions that monitor and enforce rules and regulations.
- Human Resource Development—to improve the workforce.
- Public Sector Management and Decentralization—to improve efficiency.
- The Private Sector—to enlarge its role and enhance economic efficiency.

Conclusion

Maldives' dependence on oil, fishing, and tourism makes it vulnerable to—and interested in—external markets. The ongoing structural reforms strengthen Maldives' economic security and should be encouraged.

CHAPTER 16

MONGOLIA

Introduction. After four years of "reformist" coalition parties in power, Mongolians voted for the "ex-communists"—the Mongolian People's Revolutionary Party (MPRP)—in the parliamentary election on 2 July 2000. The triumph of the MPRP, which ruled the country from the 1920s until 1996, raises the question:

Why did MPRP win? The economy still struggles a decade after communist rule ended.

- The people remain mired in poverty.
- Corruption is rife.
- A terrible winter hurt livestock production.
- Political infighting weakened the coalition government.

Economic Woes. The new MPRP government under Prime Minister Enkhbayar therefore faces tough times:

- The economy is shaky, the social welfare system has collapsed, and drought wreaked havoc on livestock herding—a major source of livelihood.
- Unemployment is officially low. The CIA estimates that about 5% of the population is jobless. However, the CIA number is misleading. A more illuminating measure of the country's economic condition can be found in the 40% poverty rate.
- In 1999, a UN study found that half the population goes hungry.

What economic strategy will MPRP follow?

Fear of communism is misplaced. Mongolia's democratic culture is well entrenched. That won't change. Nor is the MPRP headed back to communist state planning and totalitarianism.

- MPRP will slow the pace of privatization. But it has at least promised to carry the process forward.
- The old Democratic Union under Prime Minister R. Amarjargal—that came to power in 1996 with a Newt Gingrich-style "Contract with Mongolia"—is peacefully giving way to the MPRP under Prime Minister Enkhbayar, who models himself after Britain Prime Minister Tony Blair.

Figure 16-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	1.0	..	0.9	1.0
Purchasing Power	4.0	5.8	3.9	4.2
Real Growth (%)	4.9	3.5	3.2	1.1
Inflation (%)	36.6	9.4	7.6	11.6
Exports	0.5	0.3	0.4	0.5
To U.S.	0.044	0.045	0.068	0.121
Imports	0.5	0.5	0.5	0.6
From U.S.	0.034	0.020	0.007	0.017
FDI from U.S.	..	..	..	..
In U.S.	0	0	0	0
Cur Account /GDP %	2.6	-13.2	-14.1	-14.8
Fiscal Balance /GDP %	-9.2	-14.3	-11.4	-6.3
External Debt /GDP %	67.0	71.8	103.4	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Economic prospects. The new government probably will not do any better at reviving the economy.

- The MPRP does not have any new initiatives to resolve the economic problems.
- The MPRP is unlikely to make the difficult reforms necessary to attract more foreign investment.
- In fact, by slowing the pace of privatization, the MPRP may worsen corruption and inefficiency.
- All of this will jeopardize financial support from the International Financial Institutions (IFIs).
- Mongolia is already heavily dependent on foreign aid.

Why Did the Economy Falter? Western advisers got too caught up in the debate over whether to privatize quickly or slowly and neglected free market laws and institutions—the critical software of the society. While it's important to get the means of production in private hands, that's clearly not a sufficient condition for getting this post-communist economy growing again. The root cause of Mongolia's economic stagnation is structural.

Distrust. The key lies in the intersection between culture and government. Mongolian society's ability to produce wealth depends mainly on its businessmen being able to conduct transactions with reasonable confidence that the other party would fulfill his obligation. What is missing, therefore, in Mongolia's business climate is trust.

How Corrupt Political Economy Works.

Corrupt Mongolian government officials:

- Sell the myth that government ownership provides the people with a safety net.
- Control many of the common resources and turn power into money.
- Extract a cut of every transaction, a practice known as rent-seeking.
- Milk the enterprises in return for political protection. So there's little incentive to concentrate on efficiency or profits.

What should Ulan Bator do to change this rent-seeking behavior?

- Starve the rent-seeking impulse by creating transparency and fully disclosing financial data. i.e., "Stop lying, and open up your real books."
- Build a group of well-motivated and honest regulators to enforce the law.
- Encourage the growth of independent checks and balances on company managers by strengthening the accounting and legal professions.
- Foster the free market laws and institutions that allow two parties to cooperate in an atmosphere of trust.

Bottom line. Without the proper free market laws and institutions to enforce them, Mongolia continues to be a free for all—"the Wild, Wild West"—much like Russia in 1998.

Conclusions

The MPRP—comprising the so-called ex-communists—is back in power. A poor economy was a key factor contributing to their return to power.

- The good news is that democratic culture in the MPRP is well entrenched.
- The bad news is that the MPRP will likely slow down economic reforms, which will jeopardize support from IFIs.
- While a terrible winter killed livestock and damaged the economy, the root cause of Mongolia's economic stagnation is structural.
- What's missing in Mongolia are free market laws and institutions—the critical software of society.

CHAPTER 17 NORTH KOREA

Dr. Leif Rosenberger, USCINCPAC and
Mr. Brad Babson, formerly of the World Bank

Introduction. While North Korea's overall economic performance remains unimpressive, we have seen some improvement in a few pockets of the economy.

- Agricultural production has fallen sharply and famine is possible.
- On the other hand, there is evidence of growth in the non-farm sector,
- Meanwhile the euphoria of the North-South rapprochement has given way to increased tensions, with DPRK at odds with USG and ROK.

Famine and Economic Growth

North Korea's GDP grew in 2000, but at a much slower pace than the previous year.

- GDP was up 1.3% in 2000—but down from a 6.2% gain in 1999.¹
- In many ways, the picture is a mixed bag.

Bad News: Food Shortfall. Much of this slowdown is due to a collapse in agricultural production in 2000.

- Bad weather cut grain output by 15%.
- Rice production fell about 13% and corn and beans dropped 15%.

Possible Famine. Food insecurity is even worse in 2001.

- The UN World Food Program (WFP) is estimating a fall harvest 10-15% below last year's 3.0 million-ton (MT) harvest.
- About 4.8 MT are required to avert a nation-wide famine.
- Preliminary WFP estimates indicate North Korea's Fall 2001 harvest yielded about 2.6 MT of grain, the lowest level since the dismal harvest of 1997.

Humanitarian Crisis. Contrary to some reporting, the humanitarian crisis is not over.

- Food shortages continue in North Korea after a poor harvest last year and could grow worse with the recent drought, according to a 21 June 2001 statement

Figure 17-A. Selected Historical Data

	\$ Billions (or %)	'97	'98	'99	'00
Gross National Income		17.7	12.6	...	...
Purchasing Power		..	21.8	22.6	22.0
Real Growth (%)		-6.8	-1.1	6.2	-3.1, 1.3
Inflation (%)	
Exports		0.832	0.750	0.712	0.927
To U.S.		0	0	0	0
Imports		1.432	1.212	1.221	1.588
From U.S.		0.002	0.005	0.005	0.005
FDI from U.S.	
In U.S.	
Cur Account /GDP %	
Fiscal Balance /GDP %	
External Debt /GDP %	

Sources: CIA, IMF, U.S. Commerce, Heritage Foundation

from Oh Jae-shik, co-chairman of the "Third Annual NGO Conference on Humanitarian Assistance to North Korea."

Needed: Emergency Food Aid. Emergency aid for North Korea is needed to avert the effects of drought and famine.

- Only 5% of a targeted \$3.26M donation for 2001 has been confirmed, according to a 22 June statement from Kathi Zellweger, Director of International Cooperation for Caritas, who coordinates international church aid for Hong Kong.

Non-Farm Growth. Things are better away from the farm.

- If we exclude agriculture, North Korea's GDP grew 4.4% in 2000.
- The construction and mining sectors each enjoyed a strong performance. Construction grew at 13.6% and mining grew at 5.8%.
- Trade rose by one-third to \$2.5B in 2000, due mainly to higher imports.
- If the North chooses to keep its doors open to foreign investments, North Korean economic growth would accelerate.

Operating Rates Up. On the positive side, factory-operations have reportedly increased.

- Aerial photographs taken recently of 69 North Korean industrial sites reportedly showed average operating rates of 77%, up from 46% 3 years earlier.²
- Oil refining and steel are also running at near full capacity, as are thermal power stations at 87.5%.

ROK Trade Up. Similarly, North-South trade volume is improving.³

- Border trade rose 27% in 2000 to \$425M.
- South Korea is the North's third largest trade partner, after China and Japan.
- The total includes south-north aid, which rose by 24.1%.
- Actual trade grew by 38.7%, in farm and fish products as well as processing on commission—where southern firms have garments and consumer electronics made up in the North for resale.

Economic and Foreign Policy

North's Economic Outreach. This surge in North-South economic cooperation reflected improving political relations in 2000. During 2000, DPRK Leader Kim Jong-il's distrust and hostility toward the rest of the world began to fade.⁴ He began to grasp the need for change in the economy.⁵

- The process began in March 2000 with Kim Jong-il's surprise appearance at a Chinese embassy reception in Pyongyang.
- That was followed by the historic North-South Summit in June of 2000.
- Kim Jong-il then sent his second-in-command, Marshal Jo Myong Rok, to Washington in October 2000 to meet then-President Bill Clinton.
- Secretary of State Madeleine Albright visited Pyongyang in October of 2000.

The Wind is Changing. What a difference a year makes. The euphoria of the June 2000 North-South summit is gone. In its place is a new DPRK economic Cold War posture vis-à-vis both USG and ROK. Kim Jong-il has recently used summits with his old Cold War allies, Russia and China, to strengthen traditional economic ties.

- A key commercial indicator of closer DPRK ties to China is trade. North Korea's trade volume with China rose 81% for the first half of 2001 compared to the same period last year.
- North Korea is also strengthening commercial ties to Russia by planning to link railways together.

U.S. Reassessment. Had time permitted, President Clinton may well have visited North Korea before the end of his presidency. That visit may have improved U.S.-DPRK economic relations, although there was certainly no guarantee that this would happen. See below.

- In any event, the new Bush administration understandably reassessed the U.S. economic strategy toward North Korea as part of an overall reassessment of U.S. national security strategy in Asia.
- When ROK's Kim Dae Jong's visit to Washington in March 2001, President Bush publicly voiced doubts about DPRK "trustworthiness" and suspended dialogue with North Korea.

No U.S. Dialogue. After a 3-month hiatus, President Bush blessed the resumption of a U.S. dialogue with North Korea in June 2001.

- But the U.S.-North Korean sparring at the ASEAN Regional Forum meeting in Vietnam in late June highlighted the diplomatic ground lost.
- Bottom line: The DPRK failed to respond to the U.S. offer to reopen the dialogue.
- More recently, President Bush included North Korea as part of the "axis of evil" in his State of the Union address in February 2002.

DPRK Hard-Line. The deterioration of U.S.-North Korean relations also provided the North a convenient excuse to slow down the pace of rapprochement with South Korea. But the downturn in U.S.-DPRK relations is not simply action-reaction. There were actually some signs that the DPRK was shrinking back from dialogue in Autumn 2000.

- Clearly North Korea was fearful of opening up too quickly.
- This new North Korean hard line triggered delays or postponements in a number of important areas.
- The colder political climate has slowed the flow of South Korean economic aid and the pace of DPRK economic reform.

Impact on North-South Rapprochement.

- **Sunshine Policy.** The downturn in U.S.-DPRK relations prompted Kim Jong il to cancel his planned visit to South Korea. This was a blow to Kim Dae Jung's sunshine policy and his efforts to improve economic relations with North Korea.⁶ That in turn slowed down the already halting progress on two economic projects linked to North-South rapprochement:
- **Railway Stalled.** Plans for the planned reconnection of the rail and road links across the DMZ is running late due to North Korean delays and the South's refusal (for technical reasons) to meet the North's demand for instant electricity.
- **Hyundai Struggling.** Hyundai's North-South projects are struggling financially. For instance, Hyundai Asan, which organizes cruise tours from the South to the Mount Kumgang region of the North, has lost over \$300M to date. While the tours are politically pioneering, the company has failed to obtain a reduction in the \$12M monthly fee it must pay Pyongyang to operate them. Hyundai may also be unable to finance the project that it was hoping would recoup its cruise losses—a proposed large industrial estate near Kaesong, just north of the DMZ and not far from Seoul.
- **ROK Trade Down.** This deteriorating ROK-DPRK relationship also can be seen on the commercial front. In contrast to the 27.5% increase in ROK-DPRK trade in 2000, the value of inter-Korean trade actually fell by 31% year on year in the first two months of 2001.

IMF Aid? Given the stalled DPRK dialogue with the USG, perhaps the IMF can help get things moving.

- IMF said on 10 July 2001 that it is ready to provide aid to North Korea if Seoul and Pyongyang establish an open dialogue.
- IMF says it would like to send a fact-finding mission to North Korea to study how to help restructure its economy.
- The World Bank would also like to send a fact-finding mission to North Korea.
- What will be the World Bank focus?

Economic Strategy Formulation

The World Bank would presumably be addressing the following questions:

- How does DPRK rehabilitate the economy of North Korea?
- How does DPRK put the economy on a sustainable growth path?
- How does DPRK move away from a planned economy?
- How does DPRK pragmatically advance in practical ways the economic integration of the two Koreas?

Economic Challenges. Another way to think about these questions is to ask what challenges Kim Jong-il must face.⁷ They include the following:

1. Interaction with Market Economies. In the future, DPRK will have to develop expanded trade and investment relations with market economies. If the objective is to increase external economic relations and move toward Korean economic integration, then introducing market principles into DPRK's economic system is the only way to attain this objective.

- Therefore, it's necessary for North Korean economic policy makers to both learn about market economics and incorporate market thinking into their economic policies and institutions.
- There are huge challenges here in overcoming ideological biases, ignorance of economic and commercial practices, lack of businesslike behaviors, and institutional weaknesses.
- In the past, training of North Koreans in market economics and finance has been limited. This must change.
- Economic education and training will be a major need for policy makers, bureaucrats and enterprise managers. USG should help.
- North Koreans need to see economic logic, not just political logic in their foreign interactions. This will reduce misunderstandings and frustrations on both sides.

2. Infrastructure. Investment in North Korea's economic infrastructure is badly needed and will be a critical aspect of economic recovery. The investment requirements are huge. Therefore, putting the North Korean economy on a growth track will take lots of money. Unfortunately, there are real questions about:

- How to mobilize the required capital,
- How to prioritize projects,
- How to manage them well,
- And how to deal with North Korea's large existing external debt problem.
- On the positive side, Kim Dae Jung has stated his willingness to help rehabilitate North Korean infrastructure.
- However, South Korea is reeling from its own financial mess and will be hard pressed to deliver on Kim Dae Jung's lofty promises.
- Prime Minister Kim Dae Jong's sunshine policy is also under fire politically. The conservative opposition (GNP party) says the sunshine policy is gives too much away to the North. It favors an increased emphasis on reciprocity.
- Kim Dae Jung also needs to get the Bush administration to wholeheartedly support ROK's economic integration with DPRK.

3. Economic Cooperation. The international community is moving away from humanitarian assistance and toward trade, investment and development assistance in DPRK. Toward this end, there needs to be new understandings about ways of interacting and working together.

- KEDO has proven an invaluable experience in what it means to work in partnership with North Koreans. But there are many difficult KEDO issues.
- Increasingly diversified economic relations places strains on DPRK government to adapt to new requirements and expectations of development partners.
- New mechanisms are needed to support coordination of dialogue on practical issues involved with development assistance and private investment.
- The agreements made at the Summit are the first step in what will arguably be a long and winding road.

4. Commercial and Businesslike Practices.

North Koreans need to learn good commercial and businesslike practices in their relations with foreign investors and donors. To help North Korea successfully integrate, old politically motivated investments in DPRK that lack a basic economic and commercial logic must be scrapped. Simply put, teaching bad habits is the wrong way to go. Unfortunately, many existing projects in North Korea cannot pass this strict economic viability test.

- This applies both to the commercial ventures and also to KEDO. There is a need to introduce economic rationality into engagement with North Korea.
- In contrast, positive activities that will most help North Korea and need to be expanded upon include the UNDP and other UN agency projects, both in agriculture rehabilitation and in the Rajin-Sonbon Free Enterprise Zone.

5. Social Gap. A gap exists between economic reality in DPRK and North Korea's formal social policies. This poses a huge challenge. Not only can the State not provide basic human services to the population. But its ability even to feed and clothe the large urban population has been eroded by the breakdown of the State distribution system.

- The State's inability to deliver basic social services and consumption needs for its people have led to the emergence of an unofficial market economy.
- This market economy is fulfilling a social function of enabling the population to satisfy some of their basic needs through the market rather than the State.
- About 70-80% of the consumption of the urban population is now met through these markets that sell not only food but also many basic commodities.
- The State has tolerated a proliferation of these markets around the country—now estimated to have reached over 300.
- But their existence and growth is evidence of a new parallel economy emerging in North Korea that is guided by very different behavior and principles than the official economy.

Weaker Social Control. This also has major significance for social control and the relationship of the State to the people of North Korea. As the country opens up to external investment and development assistance, the impact on these social dynamics poses major questions:

- How North Korea will reconcile its internal and external policies and objectives?
- The social gap poses a real threat to social cohesion and future political developments.
- A large perception gap also exists between external reality and the understanding of the world of most ordinary North Koreans.
- This gap is likely to affect the dynamics of North Korean policy and official behavior in ways that inhibit fulfillment of many of the hopes expressed at the Summit.

6. Three Economic Systems. In addition, a big challenge is how the internal economic systems within North Korea are going to evolve over time. It seems clear that there are now three coexistent economic systems.

- First is the official state-controlled economy—mainly comprising state enterprises and cooperatives managed through the state budget and state distribution system.
- Second is the military economy, which has its own production and welfare distribution framework.
- And the third is the young and fragile informal free market economy, which as noted earlier is playing an important social role in the present distressed situation.

7. Military Resources. In addition there are a number of other key issues for the future:

- How will the resources that flow into North Korea—from South Korean ventures, official development assistance, or from other foreign sources—be distributed among these three sub systems within North Korea?
- And what will this mean for the future political economy of the country?
- Security concerns. Most importantly, we don't want economic resources to flow into

and strengthen the North Korean military economy, thereby weakening USG/ROK strategic deterrence capability.

- These internal issues and dynamics entail great uncertainty and are good cause for caution in projecting the path for the future.

8. Policy and Institutional Constraints. Even if these issues can be responsibly addressed, policies and institutions must be reshaped if infrastructure investments are going to yield the economic returns expected.

- While North Koreans may be shy about the word “reform” they seem to be more pragmatic in accepting the need for modernizing economic management.
- It is impossible to imagine how North Korea will be able to design and implement a successful economic recovery policy—even with significant financial support from the South—without finding a way to understand and come to grips with the policy and institutional constraints that they face.

Prices and Currency. Addressing macroeconomic policy issues is also unavoidable in order to send better signals through the economy for efficient allocation of resources and create an environment that will inspire investor confidence.

- A key issue is pricing policy and the overvaluation of the exchange rate.
- The official exchange rate is about 2 Won to the dollar, while the unofficial rate is 200.
- Without proper pricing, it will be impossible to proceed very far with real economic rehabilitation or cooperation.

German Mistakes.⁸ In this regard, the recent German experience provides some insight Bonn made a number of costly mistakes: It:

- Pandered to East German consumers,
- Overvalued the Ostmark (East German currency) at the time of monetary conversion,
- Created virtual wage parity between East and West Germans, and

- Destroyed the competitive position of all East German producers.

Ensuing European Disaster. These mistakes, in turn, triggered:

- Huge subsidies for collapsing East German industries,
- Bonn over-borrowed to pay for unity mistakes,
- Bonn opted for an irresponsibly loose fiscal policy (high budget deficits), which was inflationary.
- The Bundesbank offset inflationary pressures with high interest rates (monetary death grip), which in turn triggered:
 - A deeper recession in Europe,
 - European financial chaos,
 - And political disunity in Europe.
 - In short, the hasty, hysterical German unification process was a disaster.
- To avoid a similar disaster, Seoul and Pyongyang must carefully address the terms and conditions of their economic integration.

9. Legal and Financial Infrastructure. A free market oriented economy also requires a strong financial and legal foundation.

- In this regard, a positive sign of recognizing the importance of this "economic software" was the agreement during Summit for the two Koreas to start work on problems of a) financial settlement, b) guarantee of investment, c) prevention of double taxation and d) arbitration of disputes.
- Frankly, the legal and financial infrastructure for economic cooperation is just as important as the money.
- Over time, technical assistance to help develop more modern capabilities in these areas and many others will be an important part of the strategy to realize the future vision articulated at the Summit.

IFIs To a large extent, the success or failure of North Korea's economic transformation will also turn on how the International Financial Institutions (IFIs)—IMF, the World Bank and the Asian Development Bank—interact with

the key countries that play pivotal roles on the Korean peninsula.

ROK's Green Light. Kim Dae Jung and the South Korea government have been supportive of North Korea developing relations with the IFIs for some years. Since the Berlin speech, Kim Dae Jung has made numerous references in his public pronouncements about this.

US and Japanese Security Concerns The USG and Japan are the two largest shareholders in all the IFIs and have a big impact on IFI policy.

- In the past, USG and Japan concerns about security issues—missiles and nuclear program—have worked against North Korean efforts to develop relations with the IFIs.
- In the case of the US, the fact that North Korea is still on the terrorist list means that Treasury is obligated under US law to oppose any IFI expenditure of resources for North Korea.

DPRK. Even if the other key countries agree to promote IFI participation, North Korea's must unequivocally seek IFI assessment and advice on the issues faced by other countries in transition from planned to market economies.

- But this requires a willingness to open up and share information that has been closely guarded in the past.
- As of today, it is not at all clear that the North Koreans are ready to take this step, even if they have been willing to induce some economic management changes of their own making in recent months.
- In other words, the North Koreans seem to want access to IFI advice, technical assistance and financial resources. But they are hesitant about the terms and conditions that IFIs bring into official agreements and the requirement for transparency in access to information and policy dialogue.
- So some kind of understanding about the benefits of DPRK membership and overall process of how these could be obtained is still required.

IFI Bottom Line. Thus the Summit and Kim Jong Il's trip to China provide an important boost to the possibility of a future role for the IFIs on the Korean peninsula.

- IFIs are critical to orchestration of serious DPRK economic reform.
- But the progress in DPRK relations with the US and Japan will also have a decisive impact on the timing and scope of support for future IFI involvement.

Getting Agreement

Common Principles. The first things that are needed are common principles agreeable to both sides:

- Any economic integration must be peaceful and non-threatening.
- This means military as well as economic and political aspects must be addressed as a seamless web.
- Realistically, the model of economic development must be a Chinese one. Any attempt to democratize in the early part of the process would be threatening to DPRK leadership that is already hard pressed to implement free market reforms.
- Finally, economic reunification must be a step by step process. In this regard, both Koreas share the same goal of economic integration. But they are miles apart in many areas. Therefore, the process must be gradual and step by step.

Economic Goals. Both sides must also agree on how to shape economic integration.

- On the micro-economic side, the first goal must be to strengthen the self-sustaining viability of North Korean industries that still exist. That means keeping North Korea's currency weak at the time of conversion.
- Deepen and consolidate South Korean economic reforms.
- Don't bite off more than you can chew in North Korea. Focus on a few key economic zones in North Korea. Pockets of success will create further success.
- Create a viable and robust social safety net (unemployment benefits) to absorb the rising number of jobless North Koreans.

Four-phased Unity. Then Seoul and Pyongyang need to develop a four phase economic and monetary process:

- Adopt Chinese style laws and institutions, stabilize macro-economy, and create a free trade area. Avoid abrupt initial attempts at democracy in North Korea.
- Liberalize domestic prices, move toward convertibility of currency and let it float. Form a Korean Community (much like the old European Community). Pyongyang maintains political sovereignty while surrendering parts of its economic sovereignty.
- Form a German style political federation. Move to one currency and one central bank.
- Move to full economic and monetary unification (e.g., common budget) and free elections.

Perry Process. Thankfully, Washington does not have to start flat-footed on détente with North Korea. Dr. William Perry, former Secretary of Defense in the Clinton administration, started much of the groundbreaking work on developing a grand strategy that would culminate in reconciliation with North Korea.

- Dr. Perry visited North Korea and wrote a report outlining a new US strategy toward North Korea.
- While the Perry Report is classified, it's fair to say that the report contributed to President Clinton's ensuing decision to ease economic sanctions toward Pyongyang. President Clinton's actions created a new strategic setting for the Korean peninsula.
- In this sense, Dr. Perry's new policy initiatives were not simply narrow or arcane economic actions. In fact, they formed a seamless web with the other elements of comprehensive security for the Korean peninsula.

Stake in Stability. In this regard, we need to do everything possible to:

- Revive the northern economy and give the country a stake in stability.
- Encourage foreign investment.

- Foreign investment in turn will generate export earnings as an alternative to the dangerous sale of its missiles.
- Foreign investment will also give DPRK leadership rational alternatives in the future.

Paving the Way to Peace. Given slow progress in Four-Party Peace Talks in Geneva, economic integration is both a more likely route and a precondition for peace.

- Seoul and Pyongyang need to build on their positive start in the reconciliation and engagement process, which in turn could rapidly trigger moves toward deeper economic integration.

Quid Pro Quo. North Korea will always be difficult to deal with. But encouragement should be given to the process of opening its economic doors.

- In return, it is reasonable to demand more civilized behavior from Pyongyang. Being integrated into the outside world should help ensure that process.
- In short, it's time to give economic integration a chance to reduce tensions and pave the road to peace.

Crisis Prevention. To avoid a haphazard process, USG should do the following:

- Work closely with Beijing, Seoul, Tokyo and Pyongyang to come up with measured integration plans.
- Once thoughtful plans are in place, Seoul and Pyongyang can concentrate on the arduous and politically agonizing process of implementation.
- If the key actors choose to procrastinate planning for economic integration, the USG could find themselves both flat-footed and reacting hysterically.
- That would be a recipe for economic disaster for Korea and the rest of Asia. If that occurs the world would look to the USG for the distasteful job of crisis management.
- A better strategy would have been careful and early planning for economic integration and policy coordination as a means of crisis prevention.

Conclusions

North Korea's economic performance is something of a mixed bag.

- On the negative side, we see a severe food shortfall this year and a possible famine unless the international donor community can increase emergency food aid. So unfortunately, the humanitarian crisis in North Korea is still with us.
- The situation is better away from the farm. We actually see some economic growth in other sectors of the economy.

Overall, the economy remains dirt poor. Without market reforms, the economy cannot recover. Meanwhile, North Korea is slowly reforming its economy.

- For instance, North Korea has pursued economic and political outreach, both unthinkable not long ago. It now has diplomatic relations with a number of countries.
- But in 2001 a new Cold War has hardened DPRK's posture, despite Seoul's efforts to revive its sunshine policy.
- As a result, North Korea is even less likely to implement any comprehensive economic reform in the near future.

Endnotes

1 South Korean Central Bank. The bank does not include the military economy—arguably bigger than its civilian counterpart. It also does not calculate the growing role of unofficial private enterprise and markets. If the private sector were included, GDP would be much higher.

2 *Economist Intelligence Unit*, May 2001.

3 The trade figures cited earlier exclude inter-Korean trade, which Seoul calculates on an internal basis.

4 I want to thank Mr. Nay Htun, formerly Assistant Secretary General at the United Nations Development Program (UNDP) and his North Korean expert, Mr. David Fennel, for their collegial support and their insight into the economic changes developing in North Korea.

5 But the North Korean economic challenge is what to do and the method of implementation of economic reforms.

6 To make matters worse, a series of domestic policy blunders have also caused the popularity of Kim Dae Jung to plummet.

CHAPTER 18

PHILIPPINES

Introduction. After growing at 4% in the year 2000, the Philippine economy has begun to slow down.

- GDP grew at a slower rate of 3.2% in the first half of 2001. Growth is largely due to solid domestic demand.
- That said, the level of Philippine growth remains disappointing in a Philippine context. Why? It starts from a low baseline.
- The Philippines needs close to double-digit growth to make much of a dent in the persistent poverty in the region.
- Without strong growth and more vigorous outreach, the discontent that supports terrorism and insurgency will continue.

External Shocks. Unfortunately, little can be done for protection from the external winds.

- Corporations are facing weak foreign demand for electronics and other exports.
- The biggest blow has been dealt to the manufacturing sector, where first-quarter growth decelerated to 2.4% year-on-year from 4.4% in the fourth quarter.

Weak Exports. But with the Philippines' two main export markets (the United States and Japan) suffering their own economic problems, Philippine exports are falling.

- In August 2001, exports fell 26% from a year earlier, the biggest drop in 21 years. That same month overseas sales of Philippine semiconductor and other electronic components—which make up 50% of all Philippine exports—dropped 40%. Similarly, August 2001 shipments of electronics, garments, and farm products slipped 26% from a year earlier.
- Weak export figures portend continued anemic growth—or even recession.

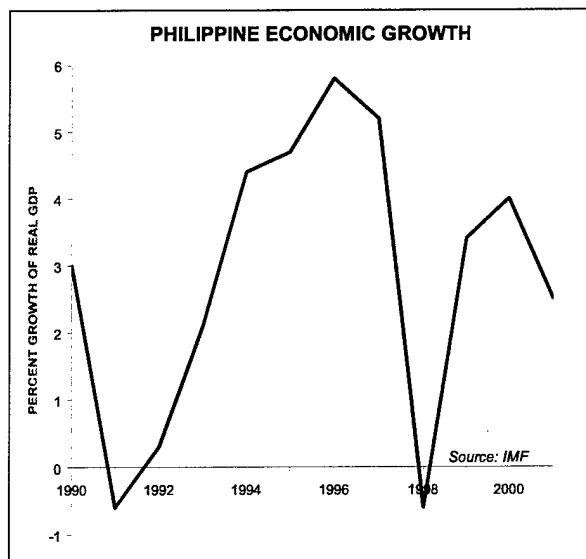
Falling Stock Market. Export fears drove down the stock market. Manila stocks ended at a 10-month low on 31 August. The terrorist attacks on 11 September only worsened the trend. By October, the stock market had hit a ten-year low.

Figure 18-A. Selected Historical Data

	\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	\$88.4	78.9	78.0	75.2	
Purchasing Power	270.0	266.0	292.9	302.6	
Real Growth (%)	5.2	-0.6	3.4	4.0	
Inflation (%)	5.9	9.7	6.6	4.3	
Exports	\$25.2	\$29.5	\$35.0	\$38.1	
To U.S.	10.8	12.3	12.7	14.2	
Imports	\$38.6	\$31.5	\$32.6	\$33.8	
From U.S.	7.4	6.7	7.2	8.7	
FDI from U.S.	3.4	3.2	3.1	2.9	
In U.S.	0.1	0.1	0.1	0	
Cur Account /GDP %	-5.3	2.4	10.0	12.5	
Fiscal Balance /GDP %	0.1	-1.8	-3.7	-4.1	
External Debt /GDP %	55.7	73.0	71.2	69.8	

Sources: IMF, ADB, World Bank, and U.S. Commerce

Figure 18-B



Economic Legacies

Estrada's Mismanagement. In January 2001, President Arroyo inherited an economic mess from Estrada, so putting the precarious economy back on track is no easy task.

- The 31-month presidency of Mr. Estrada left President Arroyo with a negative legacy of mega-corruption, poor economics, and a weaker international standing.
- The deteriorating fiscal, economic, and political picture in 2000 caused Standard & Poor's to downgrade the Philippines' outlook from stable to negative.

Arroyo's Good Start. Initially, President Arroyo made progress stabilizing the economy. Philippine financial markets rallied sharply on her ascension to power. The stock market hit

a year high of 1,954 on Mr. Estrada's removal from office. The peso also rallied, at first.

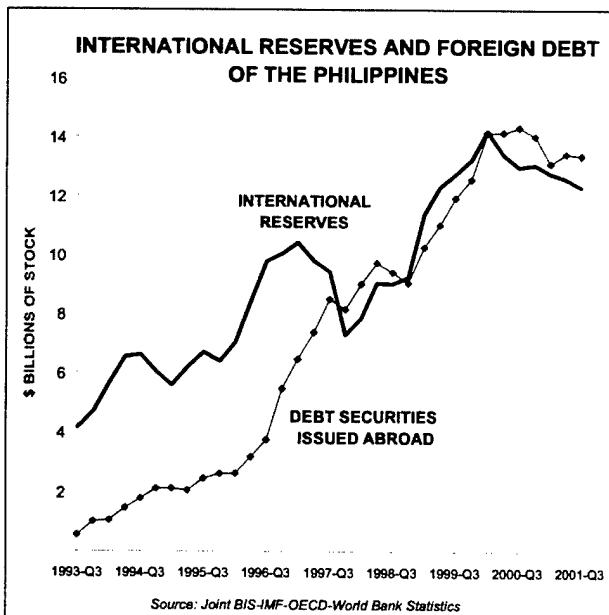
Protests Hit Markets. Then the pro-Estrada forces mounted protests against President Arroyo. For example, on April 30th, Philippine financial markets took a beating—the stock market fell 2.9% and the peso fell to a 15-week low of 51.55 pesos to the dollar.

Weak Foreign Direct Investment (FDI). Foreign investors remained jittery in 2001. Future FDI inflows depend on political stability.

Fiscal Woes. A central issue facing Arroyo is how to control a runaway budget deficit.

- Manila's budget deficit ballooned to 136B pesos (\$2.72B) in 2000, more than double the IMF target. IMF is therefore critical of this fiscal irresponsibility.
- This situation may well worsen. In October 2001 President Arroyo said that her government would boost spending to avoid a recession in the face of a severe global economic downturn.

Figure 18-C



Low Foreign Reserves. Servicing its foreign debt is another central problem for Manila.

- Foreign debt is nearly two-thirds of GDP.
- On the surface, foreign reserves look respectable at about \$12B, over twice the government's short-term debt of \$5.6B. However, foreign debt matches reserves.

Weaker Growth. Given weak U.S. and Japanese demand for exports, GDP growth slowed from 4% in 2000 to only 2.5% in 2001.

- Weaker growth will fan social unrest.
- Budget problems will worsen.

Looking for Good News

An Asian Consumer Economy. Personal consumption accounts for a sizeable 70% of the country's GDP.

Good Weather, Good Crops. When the weather is good—not too much rain, not too little—the agricultural sector does well. With more than a third of the country's workforce involved in farming, agriculture has become the lynchpin of consumer spending. President Arroyo calls it her "engine of growth."

Low Inflation. Fortunately, inflation is still quiescent as food, housing, and fuel prices fall.

Lower Interest Rates. If inflation remains low, the overnight borrowing rate, currently 9%, could be reduced. That should eventually boost growth. Even so, it will take some time before the effect of a rate cut is felt in bank lending and domestic manufacturing. Until this happens, the economy will be continuing to look overseas for good news.

Conclusion

Weak external demand for Philippine exports is dampening growth. Without stronger economic growth and more vigorous outreach, the social and economic discontent driving the terrorism and insurgent movements in the country will continue unabated.

Unfortunately, the grim legacy of President Estrada's economic mismanagement still plagues the country. On the structural side, the budget deficit has ballooned and is now almost twice the IMF target for financial stability. The Philippines is also saddled with a large foreign debt. Its currency reserves are also dangerously low. Such financial quicksand is a weak foundation for stronger long-term economic growth in the Philippines.

CHAPTER 19

RUSSIA

Introduction. Russia's economy is moving in the right direction. President Putin has a coherent economic strategy, which in turn is enhancing an impressive economic performance in a difficult global context.

- In just three years, President Putin has orchestrated a textbook economic turnaround.
- Back in 1998 the Russian economy hit rock bottom.
- Today, the Russian economy is an island of strong economic growth—albeit from a very low base—in a sea of global slowdown.
- Now comes the hard part: sustaining this economic growth, reducing poverty, and increasing economic security.
- The economic, social, and political challenges in the years ahead are daunting.

From Rock Bottom

But before we look at President Putin's economic turnaround, we need to appreciate just how bad things were before President Putin became president. The economic record of post-Communist Russia made depressing reading up through 1998:

- Output fell by 40% in real terms between 1989 and 1998.
- Inflation soared.
- Crisis followed crisis until the economy could not be patched up anymore.

Poor Country. To make matters worse, Russia was in bad shape when the crisis began. The crisis just deepened the malaise.

- Russia lags behind the wealthy Western economies by just about every conceivable yardstick.
- While a middle class is growing in Moscow and St. Petersburg, Russia's 145M people are in many ways provincial and isolated.
- In fact, 35% of all Russian people live below the poverty line.
- Per capita GDP in Russia is scarcely more than \$2,000.
- The average annual wage is about \$1,000.

Figure 19-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	394.9	337.9	332.5	251.1
Purchasing Power	631.0	580.3	928.8	1222.0
Real Growth (%)	0.9	-4.9	5.4	8.3
Inflation (%)	14.7	27.8	85.7	20.8
Exports	104.3	88.1	85.3	105.6
To U.S.	4.5	6.0	6.1	7.8
Imports	102.4	86.7	65.0	44.8
From U.S.	3.3	3.6	2.2	2.3
FDI from U.S.	1.4	0.6	0.8	0.6
In U.S.	0.2	..	0.1	0.1
Cur Account /GDP %	..	-1.6	11.8	18.0
Fiscal Balance /GDP %	..	-5.9	-4.4	1.0
External Debt/GDP %	30.5	66.8	46.9	..

Sources: IMF, World Bank, U.S. Commerce, Bank of Russia

Live By Oil, Die by Oil. These crises are nothing new in Soviet and Russian history. A key factor driving Russian crises in the past—and arguably its economic fate—is the price of oil, which is determined abroad.

- The collapse of oil prices in 1986 has played a key part in the subsequent unraveling of the Soviet economy, and later on, of the Soviet Union.
- Russian taxpayers are still suffering the economic consequences of that oil shock.
- The massive debts incurred between 1986 and 1990 to compensate for falling oil income will be a burden on the Russian budget for years to come, limiting the state's ability to respond more effectively to urgent social and other needs.

Default and Devaluation. Likewise, there is little doubt that declining oil revenues helped bring on Russia's 1998 default and devaluation.

- Starting in 1989, as the investment-starved Soviet economy effectively imploded, Russian oil production declined for ten straight years.
- When the government defaulted on its debt, Russian banks refused to perform on their forward ruble contracts.
- When the ruble was allowed to float, it nose-dived to near worthlessness.
- Foreign investors—exposed to the ruble with foreign exchange contracts in the Russian debt market—were soon jolted.

Global Crisis. Russia's devaluation and debt default set off financial shock waves.

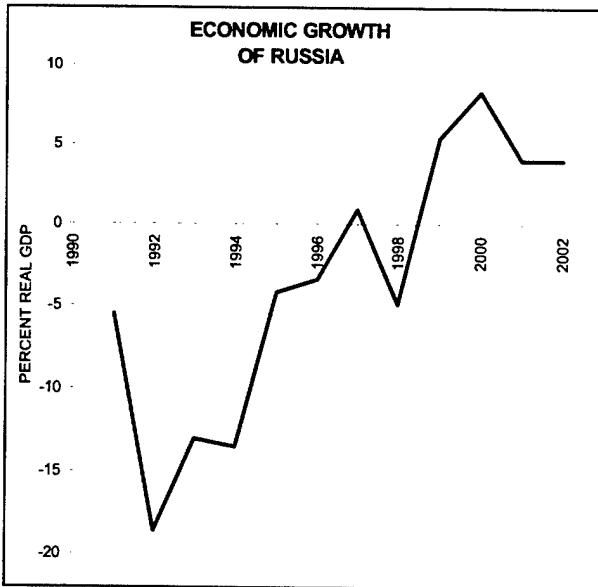
- On Wall Street, violent movements in North American stock and bond markets ensued, climaxing with the dramatic collapse of the LTCM bank in the United States.
- The world plunged into the worst financial crisis since the Great Depression.
- Thankfully, a massive injection of liquidity from the Fed averted disaster.

Bounce-back

Painful memories of the August 1998 financial crisis faded away faster than many expected. While economic problems still persist, Russia's problems today pale beside those of just three years ago.

- Russia is into its third successive year of economic expansion. (See Figure 19-B.)
- Economic growth in 1999 reached 8.3%.
- The Russian economic growth rate in 2002 is expected to slacken by one-half due to reduced global demand and the 9-11 attacks.¹

Figure 19-B



Russian Investment and Consumption Up. In addition, business and consumer spending are both up: (See Figure 19-C.)

- Retail sales went up 11.3% in September 2001 compared with September 2000 and 11.1% for a rolling average over the three months of July to September 2001.

- Similarly, fixed investment spending in September rose 9.5% year-on-year—the highest monthly increase since the start of 2001—and was up 8.6% on a three-month average.
- The numbers support impressions visible to one and all at street level. New shops, restaurants and cafes keep opening up in Moscow and St. Petersburg.
- Building renovation and construction is on the rise. This growth in construction spending reflects investor willingness to make medium and long-term commitments.

Figure 19-C



Shielded from Globalization. Manufacturing is also holding up well, with growth in July 2001 at its strongest in nine months.

- The relative isolation of the Russian market has helped insulate industry against the lion share of the global downturn of 2001.
- Russian companies sell to other Russian firms.
- Russia's only big long-distance exports are oil and gas to Europe and weaponry to countries such as China and India.

Rising Western Investment. But even in the oil business, Russia is bucking the tide of global pessimism. For instance:

- On 29 October 2001, Exxon announced the go ahead for a \$12B project with Japanese, Indian, and Russian partners in the Russian Far East.
- This Exxon oil deal will be the single largest foreign investment in Russia.
- This Exxon oil deal also paves the way to clear outstanding obstacles in the development of two other production sharing agreements—at Sakhalin 2 with Shell and in Kharayhiaga in northwest Russia with Total.

Information Technology (IT) Rising. Similarly, at a time when the rest of the world is seeing deep contraction in IT business, Russia is once again bucking the tide.

- With a 15% rate of annual growth, the Russian information technology business is expanding nearly three times faster than the economy as a whole.

Pre-payment to IMF. Russia is even repaying its financial obligations to IMF early.

- In October 2001 Russia prepaid a \$350M installment on an IMF loan due in 2003.
- IMF exposure to Russia is now only about \$10B, or just half that of its peak.

Capital Flight Declines. Although capital flight is still high, it has continued to decline.

- Only 900M a month of capital left Russia in 3Q01.
- That's much lower than either the 1.4B a month in capital flight in 2Q01 or the 1.9B in capital flight in 3Q00.
- This decline in capital flight is a sign of confidence by Russians themselves.

International Finance Corporation (IFC)

Thumbs Up. In addition, the IFC recently gave a few Russian banks a vote of confidence.

- In October 2002 the IFC indicated that it had plans to lend over \$10M to four purely Russian banks and to examine business with companies in other sectors.
- Previously, the IFC has normally only lent to foreign companies doing business in Russia or to Russian firms with foreign guarantees.

Fading Kleptocracy. In the past, a corrupt Russian business climate scared off investors. While elements of the post-Soviet kleptocracy are still visible, the business climate is improving.

- Although the mob still exists, gangland slayings—a fairly common occurrence in the early 1990s—seldom take place these days.
- And while Russian corporate leaders still resort to bribery, a growing number of companies are succeeding through savvy management and high quality products.
- For instance, Moscow based juicemaker Wimm-Bill-Dann now exports to the United States, Europe, and the Middle East.
- Attentive investors like Boeing Aircraft also see significant change in Russia's business climate and are planning fresh commitments.

Key Question: How did Putin orchestrate this economic transformation?

New Political Clout. Putin has enjoyed sufficient political clout in the Duma to push economic reform legislation.

- Putin also enjoys 70% public approval and looks to be a sure bet for a second four-year Kremlin term.
- Putin seized the political moment and pushed through economic reform. (More on this later in the paper).

Economic Drivers

On the economic front, three drivers have given the Russian economy a big boost.

- The currency devaluation.
- Oil wealth.
- Structural reform.

Currency Devaluation. Russia's currency devaluation and the debt default in 1998 were blessings in disguise. After reaching rock-bottom, the Russian economy had only one way to go—and it has been heading higher ever since.

- The collapse of the ruble in 1998 helped trigger the current recovery.
- The ruble slid from 6 to more than 20 against the dollar when the government

defaulted on domestic bonds and froze foreign commercial debt.

- That gave Russia a much lower ruble cost-base, at a time when dollar prices for its main export, oil, were rising sharply.
- In short, the currency devaluation improved Russia's competitiveness and therefore its attraction to foreign investors.

Oil Wealth. The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for Russian oil exporters. But a booming Russian oil industry reflects much more than just higher oil prices.

Improving Oil Productivity. Russian oil companies are getting smarter.

- In 2000, oil output rose 5% thanks to \$5B in capital investments. In 2001, oil output is projected to climb by 7.5%.
- The smartest Russian oil companies, such as privately held Tyumen Oil, are turning to Western energy service companies for a boost. Since 1998, Tyumen's pre-tax profits have doubled and are expected to reach \$1.4B in 2001.
- Since 1998, Russian oil producers have gone from not knowing what was depleted in a field to having production software that gives them real-time information at each wellhead.

Oil's Positive Impact. The recovery of oil prices in 1999 and 2000 transformed Russia's current account and public finances.

- Investment spending began to pick up.
- Consumers started to spend again.
- And in contrast with industrial collapse in 1990s, industrial output also picked up.

Structural Reform. While President Putin has been lucky to benefit from this more positive economic environment since he was elected in the spring of 2000, the devaluation and higher oil prices were necessary but not sufficient factors for recovery.

- Economic reform was essential for recovery.
- With no more excuses and no other options to try, the 1998 crisis forced the government to start to create the conditions for economic growth.

- In fact, Putin's administration has pushed ahead with significant economic reform.

Flat Tax. In a supply-side plan more radical than anything undertaken by President Reagan, Russia substituted a 13% flat rate tax on personal income for a complicated system that many people evaded.

- Smart move. It improved collection rates and removed many distortions.
- Personal income tax collection rose by 50% for the first half of 2001.
- Russia's economy will also get another supply-side boost from a cut in the corporate tax from 35% to 24%.
- When this corporate tax cut takes effect on 1 January 2002, Russia will have one of the most benign tax environments in Europe.

Other Reforms. The Putin administration has also implemented a number of other economic reforms that enhance long term economic growth:

- **Fiscal Responsibility.** Russia's public finances are now solid. Sound fiscal management has given Russia a large budget surplus.
- **Better Governance.** President Putin's new command over the central government has improved corporate governance: the rule of law has forced Russian companies to stop simply stealing from shareholders or bankers.

Unfinished Agenda

While Putin deserves credit for pushing a number of economic reforms through parliament, much remains to be done.

Weak Rule of Law. Russia still lacks an efficient judicial system. A strong rule of law is needed to:

- Strengthen property rights;
- Protect small investors and foreign investors;
- Improve corporate governance;
- Reverse capital flight by improving the business environment in Russia.

Legal reform, crucial to a well-run economy as well as an orderly society, is under way, but will take years, if not decades.

Restructuring of Energy Monopolies. Russia also needs to reform the national monopolies and create genuine competition.

- In this regard, there are schemes afoot to introduce more competition into the gas and electric markets and introduce more transparency into rail tariffs.
- The big dilemma is whether the government can take the political risk of removing government subsidies.
- In the short run, that would mean letting gas and electricity prices move higher and closer to market levels.
- In the long run, a new free market would encourage more competition and provides incentives for new private investment and new suppliers to enter the market.

Weak Banking System. Russia also lacks and a reliable commercial banking system.

- Reform of the financial system, dominated by state banks, has hardly started.
- Therefore, serious bank reform is a long way off.

Weak Government. The Russian government has also failed to complete the difficult transition to good governance. Infighting tends to turn almost any reform into a power-struggle.

Education and Health Care Systems. Both are essential for long term economic growth. Unfortunately, both systems remain weak and on the back burner for policy consideration.

Oil

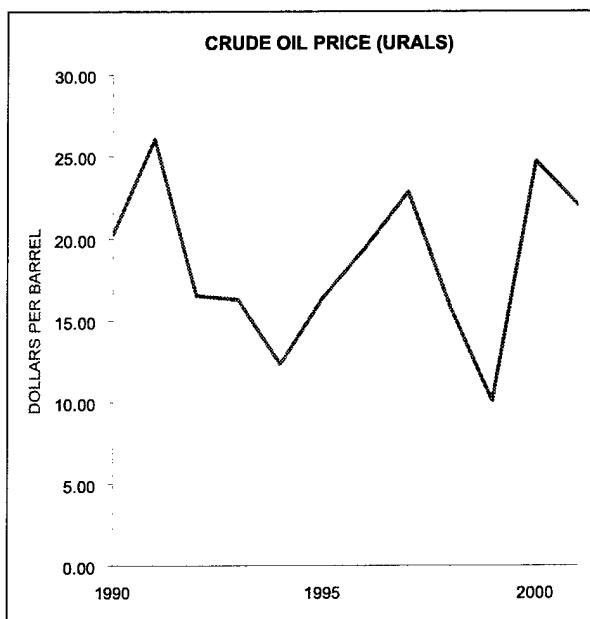
High Oil Prices: Slip-Sliding Away. Despite economic growth, the boost from the spike-up in oil prices is starting to lose its punch.

Weaker Oil Prices. The oil price spike-up is starting to wear off. That's a major concern because both the economy and government tax revenues remain dangerously dependent on the oil industry.

- Energy sales directly account for 16% of GDP and a third of federal budget revenues, sustaining equipment suppliers

and providing income for the nation's banks, law, and advertising firms, retail outlets, and restaurants.

Figure 19-D



Oil: A "Goldilocks Commodity." Oil is a lot like Goldilocks' porridge, which could never be too hot or too cold. (See Figure 19-D.)

- Similarly, the Russian economy is in trouble if the price of oil goes too high or too low.

Goldilocks' Key Questions: What is the optimum price for Russia's oil? And why is there an optimum price?

- **Optimum Price.** A price of oil of about \$22 a barrel for Urals blend oil will suit Russia nicely.
- **Not too High: Inflation.** At more than \$22 and capital inflows will force Russia's inflation rate—already too high at 18% for 2001—even higher, push up the real exchange rate of the ruble even faster, and choke off growth in the rest of the economy.
- **Not too Low: Debt Service.** On the other hand, with the price of oil falling much below \$22, as it has since 11 September, the international capital markets will begin to doubt Russia's capacity to service its large foreign debt obligations.

- **A quick rule of thumb for Russian oil:** Every \$5 drop in the price of crude costs Russia about 1% of GDP. If the oil price drops to \$15 a barrel or less, this shock will hammer economic growth.
- Russia says it can manage debt servicing unaided with an oil price as low as \$17 a barrel.
- But if worries set in among lenders, Russian companies will have little hope of raising the long-term international finance they need for investment.

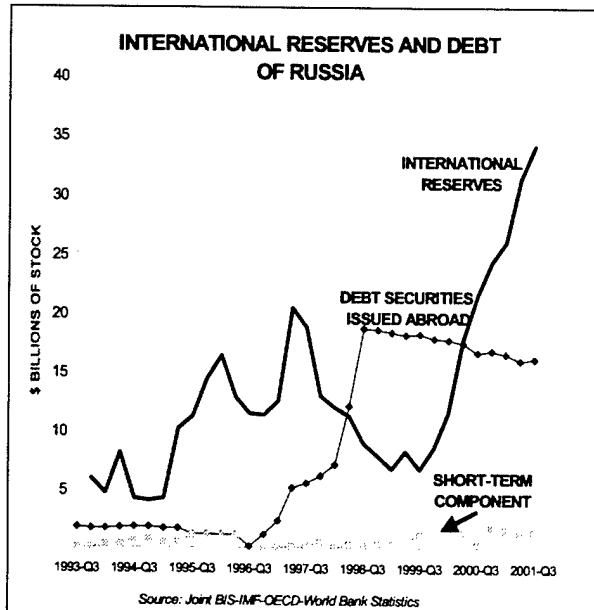
The Russian economic revival, therefore, hinges on oil prices remaining steady.

Stabilizing Oil: How can Russia maintain oil as a Goldilocks commodity at \$22 a barrel as an optimum price for oil?

Option One: Russia and other non-OPEC countries can mirror OPEC and cut oil production when the price of oil goes too low, as is the case in December 2001.

- In fact, in early December 2001 Russia agreed to OPEC urgings and agreed to cut 5% of its oil production (150,000 barrels of crude oil a day).²

Figure 19-E



Fallacy of Managing Oil Production. Attempts to micro-manage oil production generally fail.

- First, if the price is too low, Russia has no control over the size of the cuts of other oil producers.
- Second, if the price is too high, there are production limits for oil producers.
- Third, oil producers generally respond too late to macroeconomic demands for oil.

Option Two: Stabilization Fund. Does this mean we should leave the price of oil almost totally to chance and the free market?

- No. OPEC will never let unfettered free markets govern oil prices.
- But in recent years OPEC has been unable to micromanage an optimum price.
- A better approach is for Russia to set up a stabilization fund.
- How does this work?
- A stabilization fund is a government fund that smoothes short-term fluctuations in oil and gas revenues.

Norwegian Stabilization Fund. The Norwegian government started collecting revenues for its fund in 1996.³

- By June 2001, the fund had accumulated assets with a market value of about \$600B or 35% of its GDP.

A Russian Stabilization Fund. Moscow would benefit even more than Norway from such a fund.

- Russia is far more dependent on its oil commodity exports than Norway.
- Russia has a more vulnerable private economy.
- The volatility of Russia's oil industry has triggered crisis-after-crisis. So this vehicle to smooth short-term fluctuations in oil and gas revenues would be encouraging to investors.
- Russia could launch an energy stabilization fund with some of the large budget surplus accumulated in 2001.

Taming Overvalued Ruble. A Russian Stabilization Fund, if carefully implemented, would also help Moscow manage its foreign exchange problems.

- Let's look first at the looming foreign exchange rate problem Moscow faces.
- Then let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

Devaluation: Slip-Sliding Away. The current economic growth due to the boost from the huge devaluation of 1998 is starting to lose its punch.

- Russia is starting to suffer from the "Dutch Disease" in which abundant export revenues from one sector (Russia's energy sector) cause a currency to become overvalued, thus rendering other export sectors over-priced and uncompetitive.
- In other words, Russia's large current account surplus has boosted ruble balances, put upward pressure on prices, and complicated exchange rate management.
- The ruble's nominal exchange rate has held firm, meaning a strong appreciation in real terms against the U.S. dollar.
- That real appreciation has already reduced the competitive advantage Russian industry gained in 1998 by 50%.
- So all exports are increasingly less attractive.
- By the end of 2002 most of the price advantages gained from the 1998 devaluation will totally disappear.

Avoiding Dutch Disease. Now let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

- Once again, the Norwegian stabilization model provides the solution.
- All the Norwegian stabilization funds are invested overseas.
- In this way, Russia's abundant export revenues would be unable to overvalue the currency and unable to render Russia's other exports uncompetitive.
- Thus, a Russian stabilization fund would play a key role in Russia's macro-economic management, thus protecting the economy from the adverse effects of high oil revenues.

The 2003 Problem

In addition, Moscow is trying to create a sense of urgency with what it calls the 2003 problem.

- By 2003 the country's power stations, bridges, railways, and so forth will start conking out. In much of provincial Russia, this decline seems to have started to nose-dive some time ago.
- The outworn Soviet era infrastructure is a severe drag on Soviet growth prospects.
- Over the next quarter century the Soviets may need up to \$2.5 trillion to replace the old infrastructure with a state of the art infrastructure foundation needed to compete with Western economies.

"Nuclear" Swords into Plowshares. Putin is well aware of Russia's infrastructure shortcomings and is putting a plan in place to address how to finance these needs.

- Putin and President Bush have tentatively agreed to dramatically curtail the number of nuclear warheads maintained by the United States and Russia.
- Maintaining the nuclear arsenal at present levels is a huge opportunity cost for the economy.
- The nuclear cutbacks could save billions for the needed improvements in other infrastructure.

Looking West. In this regard, Putin is strengthening ties to the United States in a broad and urgently needed modernization—not just of its battered army but also its economy, schools, and legal institutions.

- On 25 October 2001, U.S. Secretary of State Colin Powell underscored this same point with the Senate Foreign Relations Committee: "It is clear that that President Putin understands that Russia's future lies primarily in the West."
- In this regard, the events of 11 September may well be a turning point for how Moscow views Washington and U.S.-Russian relations.

"Partnership and One Civilization." For years, Russia was torn between its Slavic traditions and Western culture. Not anymore. President Putin has sided with the West.

- On 21 October 2001 at a news conference with President Bush in Shanghai, Putin said, "Our priority is partnership, a partnership based on the common values of one civilization."
- Partnership with the Western civilization means integration into Western-led institutions including NATO and WTO.
- Putin hopes to convince investors that the way to keep money flowing is to continue advances in corporate governance and transparency.

Not a Basket Case. One factor that could solidify a U.S.-Russian partnership is Russia's new found economic strength.

- Russia is no longer the economic basket case it was in the Yeltsin era.
- Russia is flush with export revenues from oil, gas, and other commodities.

WTO Entry. To strengthen Russian ties to the West, President Putin is also pushing for Russia to follow China's lead and enter the WTO. But that remains a doubly controversial aim.

- Other WTO states think it may be a long time before Russia can match the international standards and practices required in the WTO.
- And many Russian companies want to put off WTO entry for fear that imports would wipe them out if tariff barriers were lowered.

U.S. Economic Interest. The improving U.S.-Russian relationship is also beneficial to U.S. national interests. In fact, Russia is also important to Washington in a way that hasn't been true since World War II.

- Russia's territory is vital for the U.S.-led war on terrorism. It stretches from the Sea of Japan to the Gulf of Finland. Iran is just across the Caspian Sea. The KGB and its successor agencies have monitored the activities of Islamic groups on Russia's borders for years.
- Russia is also a valuable source for crude oil should U.S. relations with Saudi Arabia deteriorate. Pumping seven million barrels

- a day, Russia is second only to the Saudis in oil production.
- Greater political consensus between the United States and Russia may also boost the chances for cooperation in building a pipeline from the oil-rich Caspian Sea to the West. BP, main developer of the proposed pipeline from the Caspian port of Baku to Ceyhan in Turkey, is huddling with Russia's Lukoil over possible participation.

Conclusions

After hitting rock bottom in 1998, the Russian economy is back on track. Russia is into its third consecutive year of economic expansion. Three drivers have given the economy a big boost: a currency devaluation, oil wealth, and structural reform.

The currency devaluation proved to be a blessing in disguise. It improved competitiveness, thus boosting Russian exports. The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for oil exporters. And thanks to large capital investments, oil output rose sharply in 2000 and 2001.

President Putin's structural reforms have also been essential for the economic turnaround. In particular, a flat tax on personal income has boosted tax collection. A cut in the corporate tax rate in January 2002 will give Russia one of the most benign tax environments in Europe.

That said, President Putin has a difficult, unfinished agenda. Russia still lacks a rule of law. Energy monopolies need to be restructured. Reform of the banking system has hardly started.

In addition, two of Russia's economic drivers—the devaluation and high oil prices—are starting to lose their punch. The current \$18 a barrel price of oil is moving steadily away from Russia's \$22 a barrel optimum price for oil.

Since Russia's economic revival hinges on oil prices remaining steadier, Moscow should consider a stabilization fund similar to that used by Norway to smooth short-term fluctuations in oil and gas revenues. Investing the funds overseas would avoid the "Dutch

"disease" of strong exports over-valuing the ruble exchange rate.

In addition, Russia must address the "2003 problem," in which much of the country's infrastructure will wear out. A promising way to finance replacing this crumbling infrastructure is to work with the United States to dismantle much of the Cold War nuclear arsenal, thus transforming nuclear swords into plowshares. Enhancing the U.S.-Russian economic relationship will therefore be an important element in helping President Putin orchestrate the economic transformation of Russia's economy.

Endnote

- 1 Generally speaking, the terrorist attacks on 11 September 2001 had little direct impact on the Russian economy. The one exception was the Russian stock and bond markets, which fell in Russia as they did in many other areas of the world.
- 2 Russia's so-called 5% cut in oil production is more a virtual cut than a real one. It allows Russia to get maximum PR benefit with OPEC out of its "winter reality." Each year the impact of the severe Siberian winter weather leads to cuts in oil production levels. Similarly, logistical difficulties in shipping oil abroad from stormy and frozen ports lead to drops in oil exports. This winter reality generally equates to a 5% cut in oil production.
- 3 Augusto Lopez-Claros, "Bringing Stability to Russia," *Financial Times*, 18 December 2001.

CHAPTER 20 SINGAPORE

Introduction. After remarkable 9% growth in 2000, Singapore entered recession in early 2001, with GDP changing -0.2% for the year.

- The subsequent terrorist attack on the United States and its impact on the global economy worsened the existing negative trend.
- Therefore, Singapore may be experiencing the worst recession to hit the city-state since its independence in 1965.

Dynamics

Exports Plunge. Much of the recession can be traced to the plunge in exports.

- On Monday 17 September 2001, Singapore reported a record 30% fall in monthly non-oil exports for August from a year ago. This was the sixth consecutive month of declines in exports.
- Singapore's non-oil domestic exports plunged by a year-on-year 24.2% in July. That fall followed a 16.9% drop in June.

Electronic Vulnerability. Singapore, which was the first Asian nation to go into this recession, has been highly vulnerable to the U.S. economic downturn and the slowdown in global demand for electronics.

- Electronics make up about two-thirds of the country's non-oil domestic exports.
- Singapore has a small domestic market, which means it has few buffers left against a downturn.

Manufacturing Weak. The sharp decline in demand for Singapore's electronics exports has fed through to production.

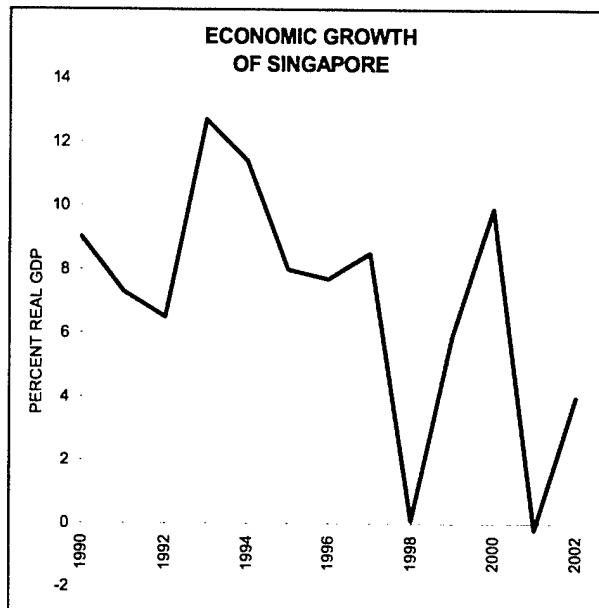
- The manufacturing sector was down a hefty 9.6% in the first quarter of 2001 (from 2Q00 to 2Q01), the weakest growth since the fourth quarter of 1985 and sharply down from the double-digit growth it registered in 1999 and 2000.
- It fell an even sharper 28% from the previous quarter (from 1Q01 to 2Q01).
- Except for financial services, all sectors registered slower growth in the second quarter over the previous quarter.

Figure 20-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	101.8	95.1	95.4	92.3
Purchasing Power	91.0	90.6	87.1	113.4
Real Growth (%)	8.5	0.1	5.9	9.9
Inflation (%)	2	-0.3	0.1	1.4
Exports	125.0	109.8	114.6	138.0
To U.S.	20.4	18.7	18.6	19.6
Imports	132.4	101.5	111.0	134.7
From U.S.	17.7	15.6	16.3	17.5
FDI from U.S.	17.5	19.8	20.1	23.2
In U.S.	2.6	1.8	1.4	7.7
Cur Account /GDP %	19.0	24.8	25.9	23.6
Fiscal Balance /GDP %	9.2	3.6	4.5	7.9
External Debt /GDP %	13.8	16.1		

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 20-B



Jobless Numbers Rise. Unemployment is rising while productivity is falling.

- The Ministry of Trade and Industry has said that as many as 5,600 workers lost their jobs in the second quarter, taking the head count of those retrenched in the first half to 9,000. The ministry estimates 20,000 job losses for 2001.
- Labor productivity fell by 5.5% in the second quarter after turning marginally negative in the previous quarter, while Singapore's unit labor costs for the manufacturing sector rose by a substantial 19% in 2Q01, following a 10% increase in 1Q01.

Government Responses. The government is struggling to stimulate growth. In August 2001, the government opted for a S\$2.2B (US\$1.3B) stimulus package.

- The economy kept contracting.
- This steep drop in exports makes it nearly certain the government would announce additional stimuli.
- Singapore is also likely to opt for supply-side measures, such as cuts in employer contributions to the Central Provident Fund (the state pension fund).

Pushing String. Will a new stimulus package work? Not decisively. Why not? Such a pump-priming measure in Singapore is ineffective because of the small size and open nature of the economy, which means any stimuli's multiplier effect can easily evaporate.

Structural Challenges. To make matters worse, Singapore's deteriorating economic performance is not merely cyclical. The political leadership is well aware that the economic strategy that delivered such impressive economic growth in the past will not work so well in the future. Why not?

- For starters, regional uncertainties are overshadowing Singapore's previously impressive economic track record.
- Economic competition with China and Northeast Asia is intense.
- ASEAN states are slow to meet the competitive challenge by re-structuring, integrating and liberalizing their economies.
- Singapore is pursuing its own domestic economic re-structuring, while seeking greater openness through regional and bilateral trade agreements.

Success Story

Singapore has, over the years, proven itself remarkably adept at solving whatever problems come its way.

- Not enough land? Reclaim some from the sea. Not enough skilled people? Import the most talented from abroad. Fertility rates falling? Offer baby bonuses to those who deliver.
- Today, unemployment is hovering just above 2% today, compared to 4% in 1998.

- Inflation remains under 2%.
- Unlike its neighbors, Singapore exhibits no signs of capital flight.
- And the central bank's robust reserves are over \$70B and growing.

Rising Foreign Direct Investment (FDI). In 2000, Singapore conspicuously succeeded in attracting S\$9.2B in FDI, 15% up on 1999. Foreign companies, predominantly from the United States, Europe, and Japan, accounted for 79% of those investment flows.

Financial Muscle. While the rest of ASEAN braces itself against the effects of the U.S./global economic downturn, the Singapore government and the commercial banks are sitting on a huge pile of cash that can cushion the blow.

- Singapore's super-conservative banking industry is actually over-capitalized. Its capital-adequacy ratios range from 15% to 22% (compared with an internationally accepted minimum of 8%). By February 2001, the total surplus of deposits over loans was S\$16B (\$8.93B).
- That means in the event of a sharp economic downturn or even recession, banks can easily continue lending without being paralyzed by non-performing loans.
- The government is sitting on huge financial resources that give it lots of elbow room to help offset the external demand shortfall. Consequently, the 2001 budget includes corporate and individual tax cuts plus S\$10B in affordable infrastructure spending.

Challenges

Vulnerability. A problem Singapore cannot do anything about—its geographical position—might well be its undoing.

- With just four million people, Singapore is too small to make it on its own.
- So Singapore desperately needs the surrounding countries of Indonesia, Malaysia, Thailand, and the Philippines to provide a stable backdrop to attract investors, while also serving as a vibrant market for its own goods and services.

Best House in a Bad Neighborhood.

Unfortunately, political and economic uncertainties are now consuming these ASEAN states and persuading portfolio and foreign direct investors to bypass the entire region for Northeast Asia. A lack of a critical mass as well as tensions in the region may well erode sustainable growth for Singapore in the future.

Northeast Asia on the Rise. Notwithstanding Singapore's past success in attracting FDI, China, Japan, Korea, and Taiwan are attracting a growing proportion of FDI coming into East Asia, at Southeast Asia's expense.

- Further undermining ASEAN is the fact that it is still integrating its less developed and newer members—Vietnam, Cambodia, Brunei, Burma and Laos.
- As with Eastern European countries in the EU, it's difficult to simultaneously deepen economic reforms and widen membership with new countries still struggling to move from central plans to market economics.

China on the Rise. FDI coming into Southeast Asia is down by about 40 to 50% compared to pre-crisis investment figures.

- FDI into China has been soaring.
- China's ascendancy has Singapore pressuring its neighbors to put aside their domestic difficulties in order to rise to the competitive challenge.

Entrepreneurial Shortfall. While the Singapore top-down economic model still appears to have some life left in it, the government is fretting that its people do not have the entrepreneurial urges needed to take advantage of the opportunities in the new economy—explaining its fervent desire to recruit international managerial talent.

- The government says that it wants to move away from rote learning and towards creative thinking and critical thinking skills.
- But it remains to be seen whether the government will relax its authoritarian social norms in order to attract the top creative thinkers from the United States and elsewhere.

Reforms

Reforms at Home. Singapore is not resting on its laurels at home either. It takes the challenge of globalization seriously. In response to the globalization challenge, its war cry is "only the paranoid survive." To attract and retain foreign investment, Singapore is attempting second generation reforms. It is:

- Liberalizing its own economy,
- Embarking on yet another wave of corporate restructuring to ensure it remains globally competitive.
- Putting into practice the corporate governance lessons of the regional financial crisis, and
- Transforming the education and business environments to encourage Singaporeans to take creative risks necessary to make it in a knowledge-based global economy.

Reforming ASEAN. It is no longer enough for Singapore to keep its own house in order. For its own success, the island must help the region to do the same. In this regard, Singapore sees itself as a catalyst or enabler, attempting to cajole the ASEAN states toward free trade and economic integration.

- Intra-regional trade is increasing.
- More air, rail, and road links are increasing the region's connectivity.
- The region is working to reduce tariffs and simplify customs procedures.

Free Trade Agreements (FTAs). But it is no longer enough for Singapore to improve the investment climate in ASEAN. For its own success, the island is aggressively pursuing bilateral free trade agreements with a dozen countries around the world.

- In a further effort to underpin its entrepot status, Singapore has concluded a free trade agreement with New Zealand and is negotiating similar arrangements with Australia, the United States and Japan.
- While this bilateral approach has been criticized by some ASEAN members as undermining the organization's own multilateral tariff liberalization efforts, Singapore has become increasingly frustrated with the group's slow progress.

Conclusion

During the first half of 2001, Singapore fell into recession. This contraction may be the worst since the its independence in 1965. Much of the recession can be traced to a 30% drop in exports. In particular, the crucial U.S. market for Singapore's electronic exports has totally collapsed. In addition, Singapore faces other formidable challenges. For instance, as a small island country, the regional political and economic uncertainties in Southeast Asia are making Singapore's political leaders feel a bit uneasy.

In this regard, the Singapore government needs to nudge ASEAN leaders toward accelerating economic integration. Otherwise, FDI will continue to leave Southeast Asia and head for China and Northeast Asia. The specter of this capital shortfall in Southeast Asia could well fan social unrest and worsen internal security in ASEAN states. Finally, Washington should consider working more closely with the Singapore government to cushion the blow.

CHAPTER 21

SOUTH KOREA

Introduction. The South Korean economy experienced a painful slowdown in 2001.

- After growing at a lively 8.8% in 2000, GDP grew only 2.5% in 2001.
- ROK's trade surplus shrunk—decreasing the net inflow of assets.
- The *won* depreciated 15% from 1100 *won* per dollar in 2000 to 1300 in 2001.

Slowdown

Origins of Slowdown. Troubles surfaced in late 2000 and early 2001.

- The faltering global technology sector weakened the demand for South Korean electronic products.
- The collapsing high tech sector triggered a shocking 12% quarter-on-quarter contraction in GDP in 1Q01.
- In late March 2001, the *won* touched a 30 month low of around 1,365 *won* to the U.S. dollar—dropping about 8% since the start of 2001.

Decline in Manufacturing. The year 2000 saw a steady deceleration of manufacturing. In 3Q01 it saw a 1.6% decline (vs. 3Q00).

- Companies first experienced a marked build up in inventory levels, reflecting the continued weakness of demand in the global technology industry.
- Companies now foresee a recovery in overall industry only when the information technology (IT) industry turns around.

Shrinking Trade Surplus. Korea's shrinking trade surplus is due to a recovery of import demand after the crisis of 1997 and to reduced global IT demand.

- The trade surplus in 2001 was one-fourth of the \$39B peak in 1998.
- Imports declined dramatically after the crisis of 1997, but now are recovering—although imports do not exceed exports as was the case before 1997.
- Total exports declined 12% during 2001. By 2Q01, the global downturn in the IT sector had reduced Korea's electronic

Figure 21-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	485.2	369.9	397.9	457.2
Purchasing Power	618.0	569.5	685.7	823.9
Real Growth (%)	5	-6.7	10.9	8.8
Inflation (%)	4.4	7.5	0.8	2.3
Exports	136.1	132.3	143.7	172.6
To U.S.	23.8	24.8	31.8	40.1
Imports	144.6	93.3	119.8	160.5
From U.S.	25.1	16.5	22.2	27.3
FDI from U.S.	6.5	7.4	8.6	9.4
In U.S.	0.6	1.4	1.9	2.7
Cur Account /GDP %	-1.7	12.6	6.0	2.5
Fiscal Balance /GDP %	-0.9	-3.8	-2.7	2.5
External Debt /GDP %	28.9	44.5	32.3	29.4

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 21-B

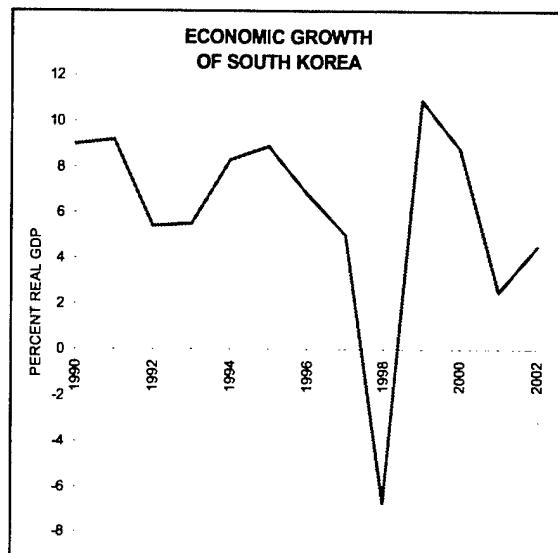
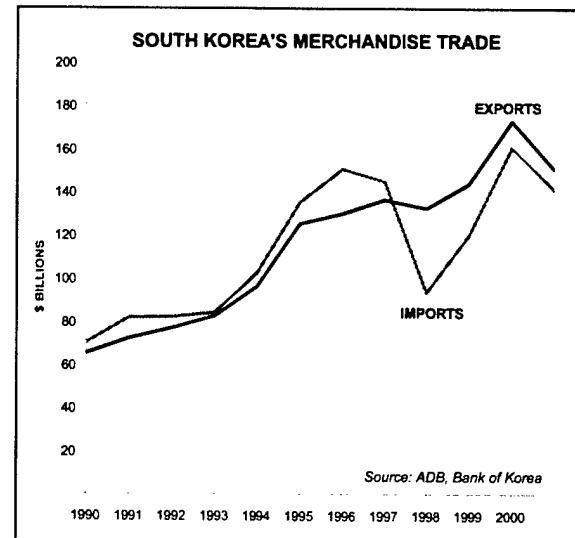


Figure 21-C



- exports by over one-fourth those of a year earlier. The trend continued through 2001.
- The *won's* depreciation served to reduce imports and help keep a positive surplus.

ROK Vulnerabilities. With nearly half of its GDP accounted for by exports, Korea's economy is vulnerable to the U.S. and global slowdown.

- IT leads the economy.
- Weakness in the important semiconductor industry is partially responsible for the downturn.
- Prices for the standard 64 Megabyte DRAM semiconductor chip have fallen sharply since early 2000.
- To make matters worse, Korean businesses tends to be highly leveraged, and a slowdown in production often leads to a sharp rise in bad debt and tension in the banking system. These tensions, in turn, cause consumers to cut back on spending.

Inflation. In addition, inflation is heating up due to higher energy costs, higher food costs (due to drought in June and rainfall and flooding in July), and a weaker *won*.

- The combination of inflation and economic slowdown has resulted in stagflation.

Divided over Stagflation. The Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE) are divided over which economic problem to highlight and which policy prescription to follow, e.g., currency policy.

- BOK is concerned that the weak *won* raises import prices and stokes inflationary fires. So in April 2001 BOK announced it was prepared to intervene directly in the currency markets by using foreign exchange reserves to buy *won* and hopefully strengthen it.
- MOFE disagreed and quickly repudiated BOK's intention to strengthen the *won*. MOFE is alarmed over falling South Korean exports (cited earlier). Since many South Korean exports go head to head with Japanese exports, MOFE says it's important for the *won* to remain weak and

competitive against a weak yen.

Troubled Recovery and Reforms

A False Dawn? It is now clear that a reversion to strong, pre-crisis growth rates has been something of a false dawn.

- At the turn of the century, the extraordinary surge in information technology spending in the United States pulled Korea—and other struggling Asian countries—out of their economic hole.
- But cyclical downturns in global markets make it all the more essential to get-right the long-term fundamentals of the domestic economy.
- In this regard, domestic demand in ROK would have been stronger if the Korean *chaebol* (conglomerates) had not become complacent and delayed the completion of their promised structural reforms.

Sluggish Corporate Restructuring. Meanwhile, the South Korean financial crisis is really not over.

- The collapse of Daewoo was arguably the worst corporate debt nightmare.
- But most other *chaebol* still have an alarming financial situation, with about twice the amount of debt to equity ratios.
- Although South Korea prides itself on doing things quickly, corporate restructuring in South Korea is very sluggish.

Credit Squeeze. The sluggish pace of corporate reform is amplified by the sheer size of corporate debt.

- This mountain of corporate debt has triggered a credit squeeze.
- Promising start-up companies—where all the growth has been this year—cannot get credit.
- The immediate fear is that South Korea could face a domestic debt crisis as South Korean corporate liquidity dries up.

Cautious Banks. The main cause of the credit squeeze is bank caution about lending.

- Banks have the liquidity but they refuse to lend to ROK corporations. Why?

- Banks refuse to lend to South Korean companies until they restructure.
- For the recovery to be stronger and more durable, Seoul will have to do more to show investors that it's putting nonviable companies into strenuous debt-restructuring programs. Unfortunately, this is not happening.
- Instead, the government in Seoul is opting for a tactical, stop-gap policy to bail out South Korean corporations.
- Faced with a sharp slowdown in 2001—the government is spending well over \$100B to shore up Korea's financial train-wreck.
- Financing is off-budget and is the equivalent of 150% of the ROKG budget or 20-25 % of GDP.

Big Gamble. The government is gambling that future economic growth, huge increases in the value of bank stocks and aggressive selling of the bonds will produce magic.

- This is a gamble that the government will probably lose.
- And if the government loses this gamble, the off-budget headache soon become a fiscal crisis.

Tax Hike Likely. In any case, the government will eventually turn to the taxpayers to bail out these over-borrowed companies.

- That means Korean taxpayers and state assets are likely to be in hock for many years.
- The problem is that the ROK continues to run a centrally planned system.
- The government keeps subsidizing sick and inefficient companies.
- Instead, banks should zero out their bad loans, not just roll them over.

U-Turn on Corporate Reform. For awhile, it seemed that the government was taking a tough line on corporate reform.

- In fact, in 2000, the government was quite willing to let the Daewoo *chaebol* fail rather than to bailout a sick and inefficient *chaebol* with a costly rescue plan.

But recently the gap between the rhetoric of economic reform and the reality has been

widening. The slower pace of reform reflects three factors:

- Global economic slowdown,
- "Reform fatigue" among the voters, and
- Kim Dae-Jung's declining popularity.

A Bailout for Hyundai. This shift has been well illustrated in the government's policy U-turn towards one of the largest *chaebol*, Hyundai. The government's determination to keep Hyundai afloat became clear in early 2001 when it brokered a bailout plan for this financially embattled *chaebol*.

- The state-owned Korea Development Bank agreed to buy 4.2 trillion won of the maturing bonds issued by Hyundai Engineering and Construction and Hyundai Electronics.
- The government's attitude to Hyundai was in direct contrast to its willingness to let Daewoo fail in 2000.
- The bailout undermines the credibility of the *chaebol* reform program—one of the main platforms of the government's wider reforms.
- The government had previously argued that it was important for sick and inefficient companies to be allowed to fail (i.e., creative destruction).
- The bailout increases the systemic risk in the banking system, retarding the return of the still ailing domestic banks to financial health.

Government Capital Reforms

Wasting Capital. The government's failure to move faster on corporate reform ranks as one of the biggest impediments to growth.

- Capital is still being wastefully allocated across too many failing industries.

Capital Shortfall. New business formation in Korea has been encouragingly robust, running at a rate 50% higher than pre-crisis levels.

- But these new companies are suffering from a dearth of capital—especially following the slide in the Kosdaq stock market index.

Will Cure Kill the Patient? At this point in the economic cycle there is a danger that the cure could be worse than the disease.

- Widespread corporate restructuring may result in big job losses, further hitting domestic demand just as the economy is decelerating.

Needed: Creative Destruction. But taking excess capacity out of some markets—such as semiconductors, for example—would increase the profitability of the remaining players and improve investor confidence abroad.

- The government has enough fiscal leeway to bolster welfare support and to stimulate demand by investing in better public transport and improving the infrastructure.

Wanted: A Coherent Economic Strategy. The government's challenge is to provide clarity and purpose.

- It should draw up a clear plan, setting out how and when it will start reducing corporate subsidies—and then stick to it.
- The tragedy for Korea is that the likelihood of this happening before the next presidential elections in December 2002 is now negligible.

A Better Way. Instead of using public resources to prop up bankrupt *chaebol* such as Hyundai, the government should shift resources to bolstering education and training for the unemployed.

- Korea's bloated *chaebol* should finally be exposed to the full blast of market disciplines.

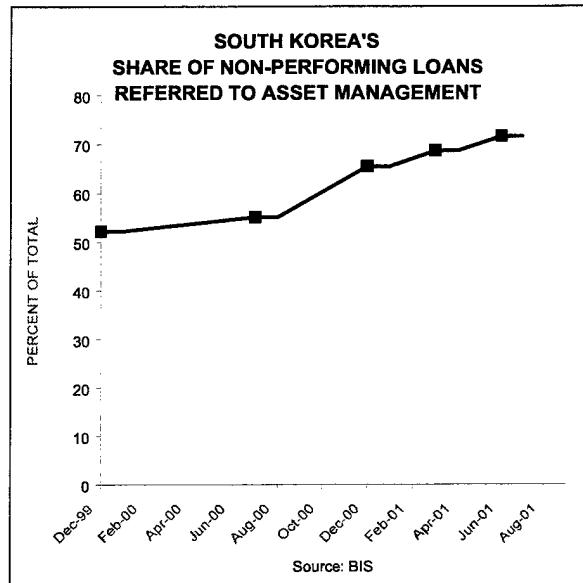
Danger of Delaying Reform. Is there an optimum time to reform? Implementing reforms can be paradoxical. When times are good, no one sees the need. When times are bad, it hurts too much.

- But delaying reform indefinitely risks triggering a crisis and magnifying the eventual pain.
- Such is the dilemma now confronting South Korea.

ROK Strengths. The good news is that the South Korean economy has important strengths that give it a fighting chance to implement the economic reforms, notwithstanding the economic slowdown.

- Record foreign exchange reserves give the Bank of Korea room to cut interest rates with less worry about an outflow of capital than it did during the 1997 debacle.
- The Bank of Korea's lower interest rates have softened the blow from weaker global demand for ROK exports.
- In contrast, in the 1997 crisis the won was linked to a rising U.S. dollar and the Federal Reserve had been raising interest rates.

Figure 21-D



Progress on Bank Reforms. In addition, Korea has at least made some progress on bank reforms after the 1997-98 financial crisis. In a number of ways, the banks are starting to clean up their act.

- The government has spent more than \$100B cleaning up the financial sector since the start of the financial crisis in Asia four years ago.
- As a result, the ROK Financial Supervisory Service (or financial watchdog) reports that the costly reform of the country's financial sector is finally bearing fruit.

- South Korea's commercial banks have managed to more than halve their bad loans during the past one-and-a-half years.
- There are now just 5.6% of loans without much of a chance of being repaid, down from 13.6% at the end of 1999.
- There is gradual progress in the share of non-performing loans being resolved by an asset management organization.
- South Korea, therefore, has made impressive progress since its financial crash in 1997-98. However, it still has a long way to go to create a sound and internationally competitive economy.

Conclusion

As with many Asian countries, South Korea's economic growth has been vulnerable to recent changes in the IT market. The key to long-term growth, however, is the ongoing improvement of the fundamentals of the domestic economy. As such, South Korea's economic reforms are a mixed bag.

- There is evidence of some progress on bank reforms.
- Initially, ROK made some progress on corporate reforms. For instance, the government let Daewoo fail. But recently, the government has done kind of a U-turn on corporate reform. In fact, the government's bailout of Hyundai is in direct contrast to how the government handled Daewoo.

If South Korea ever expects to enjoy long-term economic growth, the government should allow South Korean corporations to face the discipline of the free market.

CHAPTER 22

SRI LANKA

Introduction. If it weren't for the crippling effects of the 18 year-old civil war, Sri Lanka would likely be one of Asia's top performers. But it's tough to run a successful economy when people are shooting at each other.

War's Economic Impact

In April and May of 2000, the Liberation Tigers of Tamil Eelam (LTTE) inflicted a series of defeats on the Sri Lankan armed forces. President Chandrika Kumaratunga and her Peoples Alliance (PA)—which had recently won a narrow political victory—sharply increased military spending.

- The military budget was lifted from 52B rupees to a record 83B rupees (\$1B) for purchase of new warplanes, rocket launchers, and other hardware.
- Other government spending was cut and development projects put on hold.

Over-borrowing. Unfortunately, spending cuts were not deep enough. So the government opted to borrow the money for the plus up in defense spending.

- Consequently, domestic government borrowing rose to 8.5% of GDP in 2000 even though the target was 3%.
- Repayments on state borrowings consume 32% of government revenue.
- Total public debt rose to 97% of GDP.

On the Brink. Increased military spending, subsequent over-borrowing, and higher oil prices led to an exchange crisis in late 2000.

- The central bank faced an overvalued currency, capital flight, and low reserves.
- Foreign reserves (\$950M) covered only six weeks of imports.

IMF to the Rescue. Lacking any other solution, the government turned to the IMF.

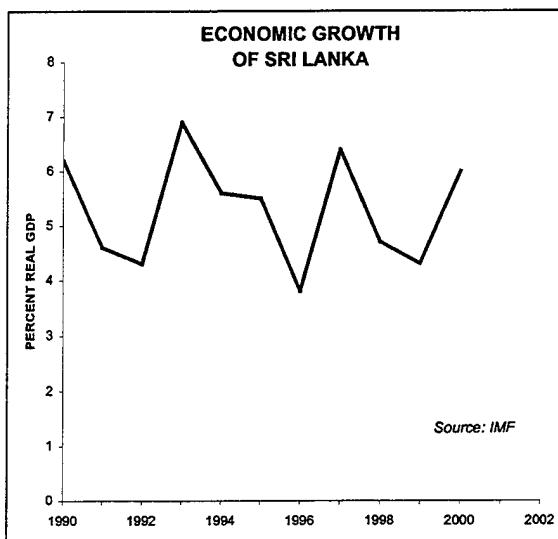
- In return for a \$253M IMF loan, Colombo had to implement market reforms—formerly delayed by popular opposition.
- The IMF released \$131M, with the remainder conditional on performance.

Figure 22-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	14.8	15.2	15.7	16.4
Purchasing Power	46.0	51.2	58.0	67.8
Real Growth (%)	6.4	4.7	4.3	6
Inflation (%)	9.6	9.4	4.7	6.2
Exports	4.6	4.7	4.5	5.4
To U.S.	1.7	1.9	1.9	2.1
Imports	5.6	5.7	5.4	6.2
From U.S.	0.2	0.2	0.2	0.2
FDI from U.S.	0.022	0.024	0.029	0.032
In U.S.	-.002	-.001	-.001	0.002
Cur Account/GDP %	-2.6	-1.4	-3.6	-6.0
Fiscal Balance /GDP %	..	..	-7.5	-9.9
External Debt /GDP %	52.1	56.0	60.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 22-B



A War-Ravaged Economy

By all accounts, Sri Lanka's economy is in trouble, with no immediate prospect of getting back on an even keel.

Slower Growth. According to the Central Bank, the growth rate for 2001 will be 4.5%, or 1.5% lower than 2000. But private analysts predict a far lower rate amid concerns over a global slowdown.

Stocks Crash. Share prices are trading at their lowest level in more than ten years.

- Share prices in 2000 were 50% below the peak of two and a half years ago.
- Since then the share index has slumped further from 449 to 419 in June 2001.

- In 1999-2000, foreign investors were the net sellers in the Colombo share market. The situation in 2001 may remain as is.

Opportunity Costs. Most development spending is suspended as the government buys more planes, artillery, and tanks with cash that might otherwise be used to narrow the fiscal deficit or improve infrastructure.

Budget problems. Given the state of the government's finances, there is little hope that it will achieve fiscal goals.

- These goals are a budget deficit of 8.5% of GDP and 25% growth in revenue.
- It is doubtful that the government can realize its long-term target commitments.

Weak Economic Fundamentals. Political uncertainty and low consumer and business confidence paint a gloomy economy.

- Huge National Debt. The country's total national debt reached 1.2 trillion rupees (\$13.9B) at the end of 2000, an amount which is expected to come close to the value of GDP for the same year.
- Foreign Exchange. The rupee initially fell to 93 rupee to the U.S. dollar after it was floated, but is now 87 rupee per dollar.
- Foreign Reserves, however, are down to 3.4 months of imports.
- Trade Deficit. The trade deficit stands at \$216M, down from \$387.1M a year ago.
- Textile Woes. The U.S. economic downturn is hammering the textile industry.

The Good News: Teas and Remittances. Tea prices have firmed, production is stable, and profits made in 2001. Further, Sri Lankan domestic workers in the Mideast earned \$1B in remittances.

IMF Strings

Now let's turn to IMF's tough conditions for its financial assistance. A key question: Will IMF and World Bank's tough medicine cure the patient or kill it?

- Samurdhi, a limited poverty alleviation program under which a family receives 500 to 750 rupees per month (\$5.5 to

\$8.25), is to be pruned back. The World Bank has plans for further cutbacks.

- Far-reaching restructuring or privatization of state enterprises is proposed. In all, 35 enterprises will be closed or sold off. About 14,000 jobs will be slashed at the Ports Authority.
- Proceeds from the privatizations will be used to repay huge government debts.
- Civil servants will receive no pay rise during 2001. There will be a freeze on hiring civil servants and the government pension scheme will be "reformed" to make the "civil service more affordable."

Financial Liberalization. In addition, the IMF has been urging the Central Bank to liberalize financial markets.

- In January 2001, the Central Bank free-floated the rupee in an attempt to stabilize soaring interest rates and protect foreign reserves.
- While imports fell and reserves were protected, interest rates remained high.
- With commercial banks' prime lending rates running at over 22%, the private sector is finding little room to breathe.
- The skyrocketing interest rates threaten the survival of many businesses.
- The float and the subsequent free fall of the currency contributed to higher inflation. The consumer price index has already risen by more than 4%.

IMF Sets Targets

The IMF has set tough government targets.

Higher Energy Prices. A timetable has been set for abolishing price controls on energy. By the end of 2001, all oil prices (including diesel) will be determined by the market. Already the price of diesel has doubled since early last year. Higher fuel prices will inevitably impact on the cost of transport and send the price of basic commodities soaring again.

A Smaller Current Account Deficit. The current account deficit is to be reduced from 6% of GDP in 2000 to 3% this year. As announced in the budget, the government

will reduce its deficit from 9.9% of GDP in 2000 to 8.5% in 2001 and 7.5% in 2002. These targets will mean a drastic cut in government spending on basic services such as education and health.

Flexible Labor Market. Changes are required to end the rigidity of the labor market, including a hire-and-fire policy to allow enterprises to determine appropriate staffing levels. One piece of legislation to be abolished is the Termination of Employment Act, which requires an employer to obtain the written consent of the employee or the Labor Commissioner before any dismissal.

Higher Tax Revenue. The general sales tax (GST), which by November will incorporate the existing National Security Levy, is to be extended to all sectors. When the National Security Levy was originally imposed, the government claimed that it was only a temporary measure while the country's civil war continued. Now the levy is to be made permanent through the GST.

Smaller Defense Budget. The government plans to reduce defense spending, but if it cannot, then "any overspending on security-related expenditure will be offset instantaneously by further measures." In other words, increased spending on the army will automatically result in cuts to further government services or higher taxes. Defense spending in 2000 was 5.6% of GDP.

Open Door to Foreign Direct Investment (FDI). In a further concession to international capital, the remaining limitations on FDI will be phased out in 2001.

Other Items. The Central Bank's report also reiterated the necessity of implementing the IMF's program, calling for the restructuring of the public sector, a reduction in the number of public holidays, more "labor reforms" and the tying of wages rises to productivity increases.

A Domestic Backlash

Implementing IMF and World Bank agreements is unpopular at home.

- Restructuring programs could well wipe out tens of thousands of jobs at the Sri Lanka Ports Authority and in the country's financial sector.
- These measures could erode working conditions for the remaining workforce.

Poverty May Worsen. Meanwhile, Sri Lanka still suffers from high levels of poverty throughout the country. Excluding the war torn northern and eastern provinces, the indicators show an average of 30% of the population living in poverty. A key question therefore is, "How will the IMF and World Bank programs affect poverty?"

- Once the IMF measures are implemented, however, the gulf between rich and poor will widen even further.
- Moreover, those hit by higher prices and the lack of jobs will also find it increasingly difficult to get access to basic services (education, health and welfare) as the government slashes spending in these areas to meet the IMF's budget targets.

Conclusions

The military escalation in 2000 and the subsequent foreign exchange crisis are part of a classic case study that shows the seamless web between military security and economic security.

- A military victory is unlikely if the economy is collapsing.
- Economic security is unlikely in a war zone.
- Any strategy that successfully addresses the economic and military instability in Sri Lanka must creatively harmonize all the instruments of power.
- In this regard, a negotiated settlement of the long-running civil war with the separatist Tamil Tigers is needed to help Sri Lanka dig itself out of its economic hole.
- The government needs to redouble its efforts to shape the conditions necessary to rebuild economic and military security in Sri Lanka.

CHAPTER 23

TAIWAN

Introduction. Not long ago, Taiwan was a global IT powerhouse.

- For more than four decades, Taiwan enjoyed 6% average economic growth.
- Compared with mainland China, Taiwan always seemed economically superior by almost any yardstick.

Recession. Not anymore. Those days are gone.

- An unexpected reversal in cross-Strait economic fortunes has left Taiwan suffering its first full-year contraction in at least half a century even as the mainland continues to enjoy impressive growth.
- GDP growth fell from 6% in 2000 to -1% in 2001, their biggest fall on record.
- Taking 2001 and 2002 together, average GDP growth in Taiwan may be the slowest over any two years in the past three decades—slower even than in 1997-98.
- As GDP falls, Taiwan's debts become more burdensome.
- Why is this happening?

Current Economic Challenges

Taiwan now faces three difficult and related economic challenges.

- Global IT Glut
- Structural fault-lines (especially a broken financial system), and
- The mainland's magnetic investment pull.

Possible Impact. Together, these three challenges may turn the government's policy toward the mainland upside down.

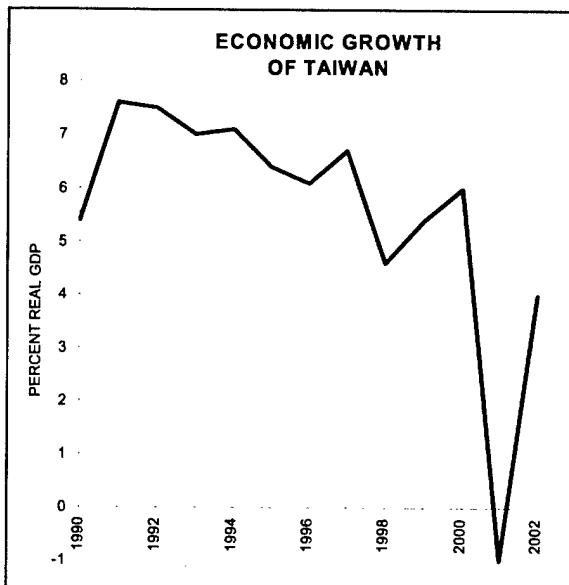
- To survive the turmoil, Taiwan's society and economy needs to reinvent itself.
- If Taipei orchestrates a successful social and economic transformation, the result could well be economic integration and peaceful coexistence with the mainland.
- If Taiwanese nationalism prevails and economic integration is politically thwarted, the result could be war with the mainland.
- The USG should continue promoting peaceful societal transformation and economic integration with the mainland.

Figure 23-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	290.2	267.2	287.9	311
Purchasing Power	327.0	362.0	357.0	376.6
Real Growth (%)	6.7	4.6	5.4	6
Inflation (%)	0.9	1.7	0.2	1.3
Exports	121.3	110.4	121.4	147.8
To U.S.	33.7	34.3	36.4	41.9
Imports	114.1	104.7	110.8	139.9
From U.S.	20.4	18.2	18.9	23.8
FDI from U.S.	4.9	4.9	6.5	7.7
In U.S.	2.9	3.2	3.0	3.2
Cur Account /GDP %	2.4	1.3	2.9	2.4
Fiscal Balance /GDP %	0.1	1.4	0.1	-0.5
External Debt /GDP %	11.6	11.6	..	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 23-B



First: High Tech Falls

Taiwan has been a victim of the disastrous decline in demand for IT-related products that in the past accounted for about 40% of Taiwan's exports by value.

- The IT glut has left Taiwan's world-class computer firms and chipmakers reeling.
- The IT glut has pushed unemployment close to 5%.
- GDP is shrinking by 1% in 2001 as IT exports continue to fall.
- The U.S. and global recession and 9-11 attacks only deepen the weak demand for IT goods.
- Pressure is also mounting on the government to strengthen the welfare

- safety net—and offset the disruption caused by two recent typhoons.
- That said, the government's first task must be to diversify and counter the effects of the vicious downward swing in the global electronics cycle.

Second: Structural Fault-lines

Policy Mistakes. While it's difficult to blame the government for the global glut in IT goods, Taiwan's economic downturn is also the result of failures of policy.

- Taiwan's investors believe that the island's economic woes are structural rather than just the result of the IT glut.
- For instance, the enfeebled banking system cramps long-term growth.
- So Taiwan's investors have been heavy sellers for more than a year.
- For instance, Taiwan's officials and politicians have known for years that the financial system needs an overhaul.
- But reforms have been repeatedly delayed, and it is only now that serious change appears to have begun.

Financial Socialism. Tough action to streamline the government and increase administrative efficiency has been blocked as many times as it has begun.

- Many companies in traditional industries such as construction or textiles have been half-dead for many years.
- These dinosaur firms are kept alive with state-directed loans and ad-hoc handouts.
- Such corporate and financial socialism has high opportunity costs.
- Government help for the worst companies hinders the better-run firms. They unfairly outbid healthy and efficient firms.
- These sick and inefficient firms don't finish their work on time and have poor quality.
- Taipei must opt for "creative destruction."
- In other words, the government should stop saving the sick and inefficient firms that are not competitive and shift capital to greener pastures.

Bad Loans. As a result of this corporate and financial socialism, the number of bad loans has soared. The government must respond.

- Bank bad loans need to be recognized and addressed.
- Hopeless borrowers need to fail.
- To make matters worse, Taipei must also tackle bad loans without putting excessive strains on the public finances.
- The fiscal deficit is already forecast to rise to 6.3% this year as a result of increased government spending and a fall in corporate tax revenue.
- That will be a difficult balancing act.
- But addressing the bad loan problem is not the only economic reform Taipei must address. See below.

Other Economic Reforms. The focus of Taiwan's efforts should be on upgrading its economy and finally implementing reform.

- Impending accession to the World Trade Organization will help shake up agriculture and some manufacturing sectors.
- But Taipei will have to avoid easing the pain with subsidies alone.
- The government must also give up the habit of frequent intervention in the politically important stock market.
- Land and labor laws need more flexibility.
- The tax base needs to be widened.
- And a more complete welfare system needs to be introduced to help solve the social wounds inflicted by such actions.
- It is a challenging task list, but Taiwan many advantages.

The Laundry List. In response to these challenges, the government convened an economic advisory conference in July 2001 with a view to forging a new political consensus about how to proceed.

- The business leaders, officials, and economists who participated in the meetings came up with 322 "unanimous proposals" for reinvigorating the economy—including pursuing faster financial reform and lifting more restrictions on cross-strait business ties.
- But the implementation of these recommendations was stalled by the legislative elections in December 2001.

Taiwan's Economic Strengths. Despite the daunting list of reforms, Taipei has numerous

economic strengths that should help them weather the storm.

- Firstly, there is a high degree of consensus about the direction of reform, even if there are still bitter battles taking place over important details.
- Also, unlike in Taiwan's northern neighbor Japan, there is no protectionist social contract that needs to be re-written; the pervasive ideology is pro-business even if past policies have not always been particularly market-minded.
- Small and medium-sized businesses remain a font of entrepreneurial energy, with ventures eagerly searching for niches to exploit in sectors ranging from biotechnology to computer chip design.
- And Taiwan still boasts some of the world's most competitive companies and an educated and adaptable workforce.

Third: Economic Integration with Mainland

Meanwhile, in a nationally broadcast "New Year Address" for 2001, Taiwan President Chen Shui-Bian's called for the integration with mainland economies, trade, and culture as, "a starting point for gradually building faith and confidence in each other."

- This is consistent with his conciliatory message in his May inaugural address.

Multiple Messages. The speech conveyed messages to Beijing and his own DPP political party. So he had to strike a delicate balance.

Message to China. Economic, trade, and cultural integration falls short of Beijing's call for a "one China principle."

- But it was constructive.
- It provides assurances to Beijing that Taiwan is not moving toward political independence.

Message to his own DPP. Economic integration goes further than many DPP hard liners are comfortable with.

- He has not convinced skeptics in his own party to totally support the proposal.
- DPP is aware that he is not giving away sovereignty in the short run.

Net Assessment. Economic integration is a good compromise.

- Chen has proposed a process of cooperation aimed at creating enough confidence between the two sides to enter into undefined political cooperation at some point in the future.

Shared Prosperity. Chen is attempting a difficult balancing act that may unravel. But his political challenges should not diminish his insightful message.

- Economic, trade, and cultural integration is arguably the most promising way to finesse sovereignty and move away from the brink of conflict in the straits.
- Economic integration gives both sides a stake in shared prosperity. They realize they have a lot to lose if they opt for war.
- That makes war less likely, although still possible. In contrast, economic nationalism makes war more likely.
- USG should work closely with both sides to shape an economic strategy.

Strategic Vision. Chen's call for economic integration starts to codify and provides an insightful strategic vision for an economic trend that is picking up speed and shows promise.

- On January 2, 2001, mini-links were established in trade, transport, and postal services between China and Taiwan.
- This reflects Taipei's unilateral decision to allow limited exchanges, thereby easing a half-century ban on direct trade.

Mutual WTO Entry. Both China and Taiwan are expected to further open direct links following their entry into the WTO.

- The mini-links policy could lead to significantly better bilateral relations.
- The financial implications of direct links between China and Taiwan for mainland cities are huge.
- In February 2002, one of a series of measures aimed at reducing barriers for companies doing business with China was implemented. Taiwanese banks with domestic banking units are now able to remit money to and from the mainland.

- Economic equities could well outweigh political strains and military tensions.

Trade. Since 1987, when the Taiwanese government began allowing people from Taiwan to visit relatives on China, cross-strait trade and economic relations have rapidly improved. The results are impressive:

- As of November 2000, total indirect trade with the Chinese mainland amounted to \$184.4B, of which Taiwan had a trade surplus of \$130B.
- Cross-strait trade was nearly \$30B.
- Taiwan imports were up 34% and exports up by 32%.
- Taiwanese businesses had a trade surplus of nearly \$20B.
- Taiwan-China trade increased 22% from January through November 2000, compared to the same period in 1999.
- Taiwan is the fifth largest trade partner and the second largest source of imports for the mainland.
- Economic analysis reveal that trade and investment have accounted for 2.5% of Taiwan's economic growth rate.

Investments. Taiwan investment in China is also impressive.

- Taiwan investment in China for the first ten months of 2000 was \$2.5B, an increase of 21% over same period in 1999.
- Up through October 2000, the number of contracted investments by Taiwan businessmen on the mainland reached 45,729, totaling more than \$46.5B, an increase of 32%.
- More than 30,000 Taiwan factories or Taiwan-connected factories are operating on Chinese mainland.
- Approved Taiwan investments in China January to October 2000 increased 98%, with over half of the investments going into the electronics sector.

Nature and Flow of Investments. Investments into China occurred under restrictive trade measures compared to natural occurrence prior to 1996. Investments were directed at China's domestic trade.

- Investment flows into China have spread from southeastern coast areas to central and western regions.
- Investment is centered in Shanghai, Guangdong, and Fujian coastal areas.
- Taiwan investment shifted from small-to-medium enterprises to medium-to-large enterprises.
- Investments focused on capital-intensive and network-related technology sectors.
- Electronics manufacturers accounted for 60% of total investment volume in 2000. This trend is a shift from previous traditional processing industries.
- Significant capital shifted from the Taiwan stock market to China stock market.

WTO Driver. Successfully arriving at a bilateral agreement between the United States and China prior to China's impending entry into the WTO was another factor contributing to the boost in Taiwan investment.

Impact of WTO Entry. WTO accession of both China and Taiwan would lead to further opening of China's domestic market.

- Cross-Strait trade policy will be adjusted—particularly by China—while liberalizing financial, business, telecommunications, insurance and travel markets.
- Both Taiwan and China would reap huge economic benefits with diminished trade and investment restrictions.
- The implications for improved and expedited trade links would mean increased investment incentives for manufacturers from Taiwan and other foreign countries, especially those engaging in export-oriented and high-tech industries.

Shared Prosperity. China and Taiwan have economic interests that complement rather than compete with one another. In short, they are natural economic partners.

- On a comparison basis, Taiwan's businesses are small in scope—lack high-tech personnel—and markets are narrow.
- China has comparative advantages in high-tech personnel, rich natural resources, and a broad market scope.

These characteristics are an attractive investment pull.

- Trade links could greatly reduce the cost and time required for freight deliveries.
- With more Taiwanese investments in China, particularly in the high-tech sectors, the division of labor and cooperation between the two countries would increase.
- Overall, intensified cooperation and resource sharing would be mutually beneficial to China and Taiwan.

Realized Investment. Skeptics point to the fact that for the past year or two, the amount of realized investment from Taiwan has fallen about 14%. Why the drop? Two factors:

- Renewed tensions in the cross-straits.
- Taiwan's restrictive trade policies limit investment flows across the strait.

No Haste, Be Patient Constraint. One of the restrictive policies impeding Taiwan's realized investment in China has been the "No haste, be patient" policy, which has been in place since 1996. Capital investment in China's high-tech sectors was not permitted and therefore usually channeled through Hong Kong, Singapore, or the Virgin Islands. Under the "No Haste, Be Patient" policy, Taiwan barred enterprises specifically from:

- Making single investments over \$50M.
- Investing in high-tech or infrastructure projects.

Taiwan President Chen Shui-bian took a pragmatic approach to dealing with the mainland, despite expressing pro-independence sentiment before he was elected in 2000.

He scrapped the \$50M ceiling on single investments in China and, prior to parliamentary elections on 1 December, gave the go-ahead for Taiwanese firms to make certain hi-tech products in China.

In 2000, only 1% of the profits from investments in China returned to Taiwan in 2000. Most profits were held in banks in third countries, primarily Hong Kong.

- Easing of the trade restrictions would allow Taiwan to reap investment returns. That in turn would give Taiwan a greater stake

in shared prosperity, economic integration, and political cooperation.

- China, as direct beneficiary of Taiwan's investments, would develop a greater stake in shared prosperity, economic integration and political cooperation.

Mainland Magnet. And, just as cracks are starting to appear in its economic miracle, Taiwan faces unprecedented commercial challenges from mainland China.

- Lured by the magnetic pull of a growing mainland economy, Taiwanese companies are shifting production across the straits.
- Cheap land and labor are obvious lures.
- Business leaders argue that Taiwan's shortages of land and labor leave them little choice but to invest in China.
- Local engineers cost just one-fifth of those at home.

Changing Perceptions. Taiwanese companies are also viewing the mainland in other positive ways as well.

- In the past, most focused on China for export production no longer viable in Taiwan.
- Now, even advanced computer chip producers see China as an important market.
- Officials used to comfort themselves that at least management, capital raising, and research and development could be kept at home.
- But now many companies plan to list on mainland exchanges.
- Taiwan firms are also training mainland managers and moving high-value operations.
- As a result, Taiwan firms do not just bring over the production lines.
- Taiwan firms also bring over R&D.
- Due to the larger customer base, sales could be much higher on the mainland.
- Corporate Taiwan also stands to benefit from Taiwan's and China's near simultaneous WTO entry, which will open the world's most populous market and its integration in the world economy.

China's Dynamic Coast. While most of the mainland remains decades behind, China's

dynamic coastal cities are often more advanced than those in Taiwan.

- Shanghai boasts infrastructure that tempts even the advanced electronics companies dominating the Taiwanese stock market.
- Mainland universities are producing electrical engineers to complement cheap line workers from inland provinces, while officials offer tempting tax packages.
- Taiwan can hardly compete on raw cost, but some investors are even saying that mainland innovations such as "one window" project approval—long talked about in Taiwan but still elusive—are making doing business in China not just cheaper but also easier than at home.
- Facilities and construction quality already surpass Taiwan in a number of areas.

Relative Calm. Meanwhile, this focus on cross-strait economic battlegrounds underlines the relative calm of overall ties.

- There has been little of the mainland saber rattling that preceded Taiwan's presidential election in 2000.
- Nor has there been any return to the tensions sparked by the 1999 attempt by Lee Teng-hui, the former Taiwan president, to redefine relations as "state-to-state."

Economic Threat? While the mainland's missile threat to Taiwan persists, zero sum economists in Taiwan feel that most pressing challenge might come more from their communist rival's commercial strength than the People's Liberation Army.

- Taiwan Business Leaps Straits. While Chen Shui-bian, Taiwan's president, has confounded the fears of many by avoiding confrontation with Beijing, his government is struggling to find ways to stem—or at least to manage—a rush of businesses eager to leap the political gulf between the two sides of the Taiwan Strait.
- Policy Change. While Chen has scrapped Taipei's five-year-old "No Haste, Be Patient" policy on mainland investment in favor of "Active Opening, Effective Management," officials are divided as to what the new approach will mean.

- On the one hand, Taipei has scrapped a \$50M ceiling on individual projects. Taipei ordered a "limited opening" for offshore islands and offered to discuss the issue with Beijing.
- On the other hand, the policy has been adjusted rather than totally relaxed. A real open door policy is still not a reality. In fact, Taipei will retain limits on total mainland investment.

Future of "One-China." Mainland insistence that Taiwan must accept the principle that there is "One-China" before it will hold any talks means links are likely to remain limited.

- That said, China could find it harder to insist on its "One-China" principles when it comes to trade.
- Why? WTO entry will change everything.
- The impending accession of both sides to the World Trade Organization will create a whole new forum for contacts.
- In the past, China has insisted that its "internal" ties with Taiwan have no place in an international organization.
- The "One-China" fixation could prove hard to sustain once both sides are in WTO, an institution with little interest in sovereignty issues.

Closer Economic Integration? Meanwhile, the longer-term strategic question facing the government is how it pursues closer economic integration with Mainland China without compromising its political claims to autonomy and its own identity at home.

- Taiwanese companies have invested about \$60B in Mainland China.
- These Taiwanese firms employ as many as three million workers.
- Many business leaders are convinced that they must shift even more production to the low-cost mainland if they are not to lose out to competitors from Japan, the United States, and Europe.

The Great Debate. In the short run, the logic may be compelling for Taiwan's companies to invest more and more Taiwanese capital on the mainland.

- Short-term opportunities to make a profit are more promising on the mainland than in Taiwan.
- But is Taiwan getting overly exposed if the Chinese economy were to turn downward?

Too Dependent? At the moment, China's economy is reportedly growing at about 7%.

- But how durable is this mainland growth?
- The state owned enterprises on the mainland are seriously over-borrowed and the Big Four state-run banks are insolvent.
- In this sense, the financial quicksand so apparent in Taiwan's own financial system may well be even worse on the mainland.
- Over the longer run, the mainland has a highly risky market and is therefore a highly risky partner to do business with.
- This zero-sum economic school says that what is a good quick buck for corporate Taiwan may not necessarily be so good for the Taiwanese population as a whole over the long term.

Policy Debate. Despite the policy adjustments, Taipei is divided over how fast to open commercially to China in the future.

- On the one hand, the nationalistic Mainland Affairs Council—the body responsible for China policy—stresses the need to avoid becoming dependent on Beijing. Such caution raises corporate hackles, but is understandable.
- Beijing is willing to mix politics and business.
- In 2000, firms considered too close to Chen came under pressure from the mainland.
- In 2001, China punished one international investment bank for organizing an overseas investment promotion led by Taipei's finance minister.

Shared Prosperity? On the other hand, the "shared prosperity" economics ministry talks of rapid liberalization of banned high-tech and large-scale investments.

- The economics ministry makes a persuasive positive sum argument that the financial security of the island and the mainland would be stronger and long term

economic growth for both would be more durable if the mainland and the island increased economic integration.

Corporate Culture Challenge. Critics on Taiwan also say the mainland is "hollowing out" the island's industrial base.

- But clinging to its manufacturing base is no vision for Taiwan's future.
- Eventually Taiwan needs to "go up-market" and make the shift from a predominantly manufacturing-based economy to one based more on services, research, and development.
- This shift would also be a recipe for any harmonious economic integration with the mainland, with each side focusing on its comparative advantage.
- Only then can Taiwan's economy hope to absorb the labor shed by the shift of manufacturing capacity to the mainland.

Conclusion

Can Taiwan Change? Questions are being asked about whether the Taiwan economy will be able to reinvent itself.

- After all, such a shift in Taiwan's economic strategy ultimately requires a dramatic change in Taiwan's corporate culture.
- Many Taiwanese companies would have to change the way they operate.
- And many Taiwanese people would have to change the way they think.
- That will be no easy task.

CHAPTER 24

THAILAND

Introduction. In January 2001, Thaksin Shinawatra and his Thai Rak Thai (Thai Loves Thai) party beat Chuan Leekpai and the Democrat Party in the biggest popular mandate and the first clear majority in nearly 70 years of electoral politics.

- Mr. Thaksin ran as a self-made telecommunications billionaire.
- He ran as a populist willing to spread Thailand's wealth to the rural masses.

Economic Inheritance

When Mr. Thaksin took power in January 2001, he inherited an economy that appeared to be doing well, at least on the surface in 1999 and 2000.

- GDP was up 4.2% in 1999 and rose again at a 4.3% clip in 2000.
- In the year 2000, trade was booming. Exports—which contribute 65% to Thai GDP—were up 10% in 2000 and served as a major force driving recovery.
- A strong current account surplus replenished lost foreign reserves. At \$32B in 2000, foreign reserves were robust and near their pre-economic crisis levels.
- Inflation was only 2%.

Economic Downturn

But below the surface, homegrown economic vulnerabilities made the Thai economy ripe for a jolt. That jolt was the collapse of the U.S. demand for Thai exports.

- The collapse of U.S. demand was particularly painful to Thailand because the United States traditionally buys 25% of Thailand's exports.
- Following relatively strong growth in 2000, the economy is now losing momentum and may even dip into recession.

Exports Fall. The U.S. and global economic slowdown hammered Thai exports.

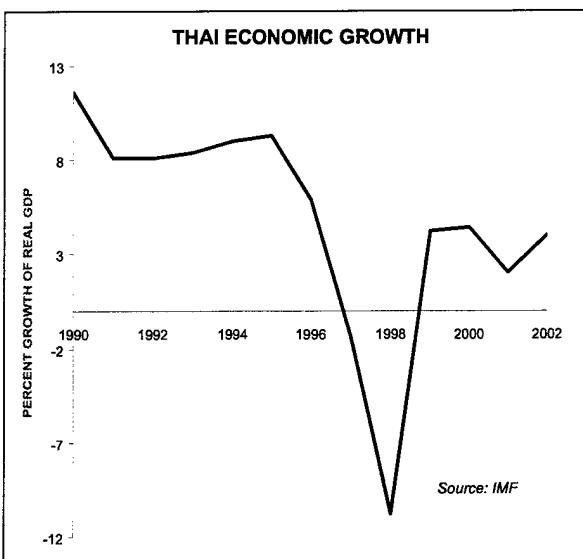
- Exports grew at a robust 19.5% in 2000.
- Since Thaksin took office in January of 2001, Thai exports have stalled. In 1Q01, exports shrank by 3.5% year-on-year.

Figure 24-A. Selected Historical Data

	\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	\$ Billions	165.8	134.4	121.0	121.9
Purchasing Power	\$ Billions	393.0	356.9	345.4	389.0
Real Growth (%)	%	-1.4	-10.8	4.2	4.4
Inflation (%)	%	5.6	8.1	0.3	1.5
Exports	\$ Billions	57.6	54.3	58.5	69.3
To U.S.	\$ Billions	13.5	14.0	15.0	17.2
Imports	\$ Billions	61.4	42.9	50.4	62.2
From U.S.	\$ Billions	7.4	5.2	5.0	6.5
FDI from U.S.	\$ Billions	3.5	5.7	6.8	7.1
In U.S.	\$ Billions	0.2	0.2	0.3	0.1
Cur Account /GDP %	%	2.0	12.7	10.2	7.7
Fiscal Balance /GDP %	%	..	-2.4	-2.8	-2.2
External Debt /GDP %	%	68.9	76.3	61.1	50.9

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 24-B



- Falling exports pushed Thailand's terms of trade into deficit. That export shortfall will deepen as global demand for semiconductors—which make up 35% of Thai exports—slows.
- Thailand's two chief trading partners, Japan and the United States, demonstrate signs of continued economic weakness.
- UBS Warburg in Bangkok predicts Thai exports will contract by 8% in 2001, which would almost certainly drive Thailand into a painful recession.

Socioeconomic Woes. Meanwhile, workers are still hurting:

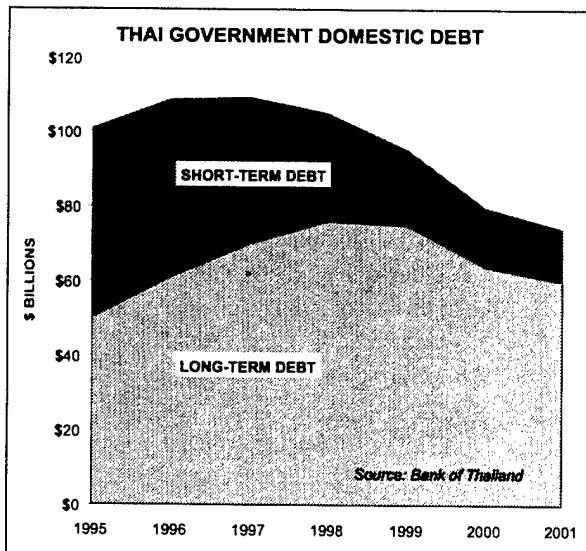
- Wages for low skilled workers dropped 13% to 20% after the crisis and have not recovered.

- While the official unemployment rate is only 4.3% (over four million people), these numbers appear to be too low. Millions more jobless don't show up in the official figures.¹
- Private sector research is consistent with media reports from the streets of Bangkok, which give the impression of widespread unemployment.

Fiscal Constraints. Moreover, one of Thailand's prime economic drivers—government spending—is unsustainable. Why?

- During the past few years, large fiscal stimulus packages—worth over 300B baht—have temporarily been force-feeding much of the economic revival.
- However, this kind of big spending is running up huge budget deficits. The day of reckoning is near.
- The government is now burdened with a national debt that's 52% of GDP (2.6 trillion baht). (See Figure 24-C.)
- Plans for a 105B baht fiscal stimulus package for 2000/2001 will push the national debt closer to 60% of GDP—another Maastricht alarm bell for financial instability. (More on this later).
- The budget for debt service alone will increase from 9.5% of the total government budget in 2000 to 17.1% by 2003.

Figure 24-C



Negative Drivers. In addition, a number of other economic factors have weighed down the Thai economy, including:

- Rising oil prices, which require higher interest rates to offset inflationary pressures.
- Sluggish consumption at home. (A weak baht buys less).
- Political instability while Prime Minister Thaksin was on trial. (More on this later).
- Long term Thai economic growth depends on implementing deep and comprehensive structural reforms.
- Unfortunately, the cosmetic economic reforms Thailand has opted for won't work for long.
- This is particularly true in the fragile corporate and banking sectors.

The Bad Loan Problem

Vestiges of the Asian economic crisis are readily apparent in the banking sector. In fact, the most urgent problem facing Bangkok currently is tackling the mountain of bad loans that companies cannot or will not repay.

History. An excess of private rather than public capital provoked the financial crisis that began in Thailand in July 1997. Many private debts were short-term loans borrowed in foreign currencies. This money was often squandered on speculative projects, especially land and property. When property values, stocks, and the Thai baht collapsed, Thai companies were faced with massive debts, especially if they were denominated in U.S. dollars—as was frequently the case.

Corporate Debt. Some Thai companies are too broke to repay the loans. Other companies are stalling in the hope that creditors will offer better terms or write off part or all of the loans. For the moment, there is little that creditors can do about this. That's because bankruptcy proceedings can take years in Thailand, allowing ample time for assets to be spirited away.

Reluctant Banks. Consequently, Thai banks are reluctant to lend, even to deserving companies desperate to expand as the economy recovers. Thai banks are also

reluctant to lend because they face a strict provisioning requirement for bad loans.

Slow Progress. Back in 1999 bad loans amounted to nearly 50% of all loans in the financial system. Thankfully, the level of bad loans is gradually falling. But three years after the baht's collapse, Thai banks' bad loans still account for over 35% (\$50B) of all outstanding loans in April 2000, largely because many restructured loans have gone bad a second and a third time. In other words, a third of the bad loans are non-performing even after being generously restructured.

Financial Millstone. Thus, the bad loans are still a millstone around the financial system's neck, choking new bank loans to a trickle and discouraging foreign investment.

- This squeeze keeps most Thai companies—particularly small and medium-sized ones—starved of the funds they need to get back on a sound footing.
- And with stocks down 37% in value in 2001, businessmen have nowhere else to turn to raise capital.

Corporate Woes

Meanwhile, the family-owned conglomerates—at the core of Thailand's manufacturing economy—remain moribund. Many such businesses operate with no profits and with factories running well below capacity, if at all.

- Rescheduling debts have helped some companies stay open. But until companies work out their debts, creditors will shy away from new loans for upgrades and modernization.
- These corporations are also largely unwilling to surrender management control and incur losses by streamlining operations. If these companies stay on life support, they are simply postponing the day of reckoning.

Tar Babies. Sadly, even those Thai businessmen who are responsibly trying to implement comprehensive corporate restructuring are getting tarred with the same brush as the deadbeats.

- They find it increasingly difficult to sell assets or raise new equity.

- That's because Thailand simply isn't high on the list of foreign investors.

The Investor's View. But investors say that until Thai companies lower their asking prices for assets, foreigners will be wary of buying in. Why?

- Bankruptcy courts still operate slowly, if at all.
- While foreigners want a discount for risk, many Thai companies still demand a premium.
- Thus there's a large valuation disparity between creditors and debtors.
- Thai companies simply don't want to part with their assets.

Needless to say, that's risky short-term thinking.

Restructuring: Lessons Learned

What does experience teach us about Thai corporate restructuring?

- Unfortunately, the quality of much of the corporate restructuring is poor.
- Some three-fourths of the so-called restructured loans has been merely rescheduled.
- Banks have swapped equity for debt to avoid writing off loans.
- Too much of the old, incompetent management responsible for the bad loans and financial crisis are still in place.
- Lack of buyers has hobbled attempts to streamline companies through the sale of non-core businesses.
- Banks have dealt with easy cases first. Future cases will be thornier.
- Many of the loans are relapsing into non-payment.

Vulnerability Factors

The China Threat. These Thai corporate problems are increasing Thai vulnerability in head-to-head competition with China.

- China is aggressively taking away many of the country's traditional, low-skill industries.
- Thailand's rote learning education and training system makes it difficult to "move up-market" into a more value-added market niche.

- In addition, the lack of progress in Thai corporate reform is sapping international confidence.

Weak Legal System. Thailand must also strengthen its weak legal system if it hopes to be economically competitive.

- In this regard, one of the chief economic challenges for Thailand is to curtail the culture of arbitrary rule that has bedeviled the country's economic development and contributed to its financial crash in 1997.
- At a minimum, the rigorous and impartial application of the law is the precondition for good economic governance in Thailand.

Thaksin's Test. The rule of law was tested in 2001 when Prime Minister Thaksin was indicted for concealing huge assets when he was Deputy Prime Minister in 1997.

- Mr. Thaksin did not dispute the charge.
- Instead, he said that the tax rules and regulations were "confusing" and that he made an "honest mistake" in concealing millions of dollars in assets, manipulating stocks and evading taxes.

Thai Sovereignty. The U.S. government correctly did not and will not take sides.

- Washington respected Thai sovereignty and viewed the indictment and legal decision as a sensitive Thai internal matter.
- Nevertheless, the market was not and will not be so sensitive to Thai sovereignty. The indictment and the legal decision have profound financial and economic consequences.

Thaksin's Acquittal. In the end, Mr. Thaksin was acquitted. What does this decision say to the market about the Thai legal system?

- The fact that Prime Minister was actually hauled into court shows how far Thai law has come in recent years.
- Such an anti-corruption indictment would have been unthinkable not long ago.

Immediate Impact. Initially, stock market investors greeted the acquittal with relief, pushing the stock market up 4%.

- The acquittal removed the biggest cloud over the prime minister and thus reduced Thai political instability in the short run.
- Mr. Thaksin is now free to focus on reviving the economy.
- The court paved the way for a rebound in domestic sentiment, which could spur fresh consumption.

Long Term Impact. On the other hand, investors say that the impact of the acquittal may not be altogether favorable in the long run. Why? The perception is business as usual in Thai politics.

Alternative Scenario. In contrast, what if Mr. Thaksin had been found guilty?

- What would investor perceptions be like?
- In the short run, political instability would increase.
- Over the longer run, the market may well have seen it as heralding in a new era of political reform.
- Either way, many potential foreign investors are stymied by the confused separation of powers between executive and judicial functions.
- These investors seek reassurance that the rule of law applies to government officials and businessmen alike.

Interest Rate Battle. Many foreign investors are losing confidence in the Thai government for other reasons as well.

- Prime Minister Thaksin's firing of central bank governor Chatu Mongol Sonakul has worsened investor concerns about Thai financial policy.
- At a time when the Thai economy is on the verge of recession, the economy faces an obvious shortfall in aggregate demand.
- In response, the Harvard-trained Chatu Mongol was following a low interest rate policy that any sensible central banker would pursue to boost aggregate demand.
- In fact, the Fed is pursuing a similar low interest rate policy to fight slow growth in the United States. This is Keynesian Economics 101.
- When Thai central bank governor Chatu Mongol Sonakul refused to cave into Prime Minister Thaksin's pressure to raise

interest rates, Mr. Thaksin fired him in late May 2001.

Monetary Policy

Monetary U-Turn. Thailand's new central bank governor Pridiyathorn Devakula radically reversed the low interest rate policy of his predecessor and announced that inter-bank rates would be raised.

- What is Thaksin's rationale to push the "Herbert Hoover" button and tighten monetary policy in the midst of weak growth/recession?
- Thaksin voiced concern in June 2001 that the Thai exchange rate is 45 baht to the dollar—a decline of 15% since the spring of 2000.
- To help stabilize the baht, Mr. Thaksin decided to use high interest rates to limit capital outflow and keep foreign reserves at around \$32B.²
- Thailand's new central bank governor Pridiyathorn Devakula also says he wants to "manage" the value of the baht and reduce currency volatility.

At best, this nonsensical economic theory will only work in the short run.³

Monetary Mistake. The decision to raise interest rates in the midst of weak growth/recession is a huge mistake. Why? Higher interest rates:

- Shrink aggregate demand even more, thus making it increasingly likely that that weak growth will turn into a recession.
- Force banks to charge more for loans—making it more expensive to finance everything from car purchases to new factories.
- Discourage fresh investment.
- Raise government financing costs, thus crowding out discretionary spending.
- Add to the woes of the debt-burdened corporate sector.
- Stop Thailand's recovering banks in their tracks.

Crippling Bad Loans. In this regard, higher interest rates will spell disaster for the profit margins of embattled private banks, which face a stagnant lending environment and a dearth

of non-interest income streams. The banks' weakened state is seen in a number of ways.

- Non-performing loans (NPLs) account for nearly 20% of the total loan book or Bt854.7B—down from the peak of 48% in May 1999, according to official figures.
- However, the published balance sheets tell only part of the story. The banks are reportedly heavily under-reporting NPLs.
- The headline NPL figures do not include loans secured with dubiously valued collateral or loans that have been "restructured" with token, extended repayments.
- As a result, the banks' average yield on assets remains poor and the net spread between deposit and lending rates is a narrow 1.8% on average.
- The level of non-performing loans could grow to twice the current levels.

Government Response

The government has sought to facilitate their recovery, in part by:

- Bailing out some of the banks.
- Aiding sales of other banks.
- Unveiling the National Asset Management Corporation (NAMC).

State Bank Bailout. A key element of Prime Minister Thaksin's economic program is the NAMC, a government asset management company whose job is to carve out bad debts from the banks.

- The mission of the NAMC is to absorb up to Bt1,350B (\$30B) of NPLs from the balance sheets of banks.
- The good news is that NAMC has strong powers to force restructuring.
- However, bailing out sick and inefficient state run banks all too easily degenerates into politicians giving breaks on "political loans" to influential borrowers.
- That sends the wrong signal to private companies struggling to repay commercial loans to private run banks.

Private Bank Bailout. To rectify this preference for state run banks, the Thai government extended the bad loan bailout plan to private banks.

- The government said that it intended to give strong powers to an Asset Management Corporation (AMC) to force defaulting borrowers to restructure their debts. These powers would include the ability to seize assets swiftly.
- The plan calls for the AMC to buy up all bad loans at state banks and up to Bt250B worth of bad loans from private banks, paying net book value for the assets.

Funding Bad Debt Buy-Out. Another problem is how to pay for the government's bad debt buy-out. The buy-out fund will place a great strain on public finances.

- Recent government budget deficits have been approaching the 3%-of-GDP alarm bell established by Maastricht as a rule of thumb for financial instability.
- An enlarged budget deficit to finance the bank loan bailouts should only be implemented after consideration of the long-term implications of deficit financing for public debt.
- Public debt has skyrocketed from 48% of GDP to 58% in just one year.
- If this accelerating public debt buildup continues, the government debt would easily spillover over the Maastricht alarm bell for financial instability—government debt over 60% of GDP.
- Certainly Prime Minister Thaksin's plans to boost government spending for the bailout should not be allowed to push the budget deficit in excess of 4% of the country's GDP, or it could hurt the state's ability to manage public debt.
- To get around this alarm bell, Mr. Thaksin may push his newly politicized central bank to print money to fund the bailouts as well as his health care and rural development programs.
- This course of action could trigger inflation.

The Way Ahead

Prime Minister Thaksin was elected as a big-spending populist.

- Many observers assumed from his business acumen that he supported open markets. Now people are wondering if he will roll back reforms.

- The biggest fear is that Mr. Thaksin's desire for a strong baht will result in capital controls, as Malaysia did in 1998.
- The specter of Thai capital controls and a pegged exchange rate regime have become a distinct possibility.
- That would send investors fleeing.
- If Thailand is to increase its long-term economic security, Mr. Thaksin must stay the course and deepen economic reforms.

Conclusions

The Thai economy is on the verge of a recession. The major negative driver has been the collapse of the U.S. appetite for Thai exports. The resulting bad news includes a falling baht, nose-diving stocks, low wages and unofficial reports of higher unemployment.

Meanwhile, a strong recovery is unsustainable due to homegrown economic faultlines, which include high budget deficits, a large national debt, sluggish consumption, political uncertainty and weak economic reforms. High oil prices compound these problems.

The most urgent problem facing Bangkok is the mountain of bad loans. Bad loans choke off new bank loans and discourage foreign investment, thus slowing down long-term economic growth. While the government has come up with generous plans for loan bailouts of the state and private banks, it's not clear how the government can pay for these plans without straining public finances.

Finally, it will also be no easy task to change the mindset of the crony capitalists and their iron triangle of politicians, businessmen, and politicized bankers. For the foreseeable future, the Thai bad loan problem will continue to be a millstone around the neck of the financial system and therefore a huge constraint on long term economic growth.

Endnotes

- 1 Thai Farmers Bank Research Center (TFBRC).
- 2 Prime Minister Thaksin's decision to have a politicized central bank under his thumb could well contribute to the capital outflow that so concerns the government. Conversely, a strong, independent central bank would attract capital inflow.
- 3 See the first two chapters for why currency micro-management is a bad idea.

CHAPTER 25

VIETNAM

Introduction. Vietnam's economic performance remains well below its potential. What's the problem?

- Slow economic reforms continue to discourage foreign investors.
- Without a recovery in foreign investment, a return to the rapid economic growth rates of the mid-1990s is unlikely.

Background on Growth. Prior to the Asian economic crisis, Vietnam enjoyed strong economic growth. On average, the economy grew at an 8.8% annual rate in the five-year period from 1993 to 1997. At this rate, Hanoi was starting to make a dent in its poverty.

- In the wake of the Asian economic crisis, Vietnam recorded GDP growth rates of 3.5% in 1998 and 4.2% in 1999.
- While the economy grew at a 5.5% clip in 2000, 7% to 9% GDP growth is needed to reduce Vietnam's poverty.
- The slowdown in the U.S. and Asian economies is dampening Vietnam's economic performance.

Economic Problems

The reasons why growth is currently not faster can arguably be linked to economic weaknesses in five main areas:

Foreign Direct Investment (FDI) Shortfall. Strong inflows of foreign capital drove the economy in the mid-1990s. These have drastically fallen away.

- According to World Bank figures, foreign investment inflows fell to an average of \$600M per year in 1998-2000 compared to \$2B per year between 1995 and 1997.
- Until foreign investment increases significantly again, growth is likely to remain below the highs of the last decade.

Agricultural Impasse. External and internal factors are hurting farming.

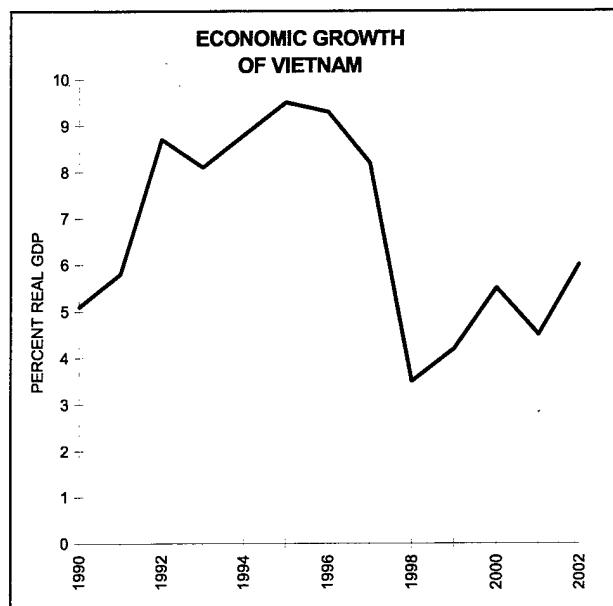
- On the global front, low world commodity prices hurt farming incomes.

Figure 25-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	24.0	25.6	28.2	31.4
Purchasing Power	1220	143.5	136.1	159.1
Real Growth (%)	8.2	3.5	4.2	5.5
Inflation (%)	3.2	7.3	4.1	-1.7
Exports	9.2	9.4	11.5	14.3
To U.S.	0.4	0.6	0.7	0.9
Imports	11.6	11.5	11.6	15.2
From U.S.	0.3	0.3	0.3	0.3
FDI from U.S.	0.015	...	-0.014	-0.054
In U.S.	0	-0.004	-0.006	-0.007
Cur Account /GDP %	-6.5	-4.6	-4.1	1.7
Fiscal Balance /GDP %	-4.8	-2.6	-2.8	-4.5
External Debt /GDP %	78.9	82.8	81.1	...

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 25-B



- Domestically, rural areas are consistently failing to secure higher levels of public and private investment.

Red Tape. Vietnam is still a high transaction-cost economy. This is linked to the large amounts of government red tape that affects both domestic and foreign investors.

- Obtaining the necessary permit or license is frequently time-consuming and inevitably increases costs.
- The fact that businesses often see the payment of bribes as necessary to speed the licensing process, or simply ensure its success, also pushes up overall costs.

Public Sector Mismanagement. Inefficient use of public resources is also exerting a drag on the economy.

- Ironically, the partial dismantling of the centrally planned economy has not produced a fall in the size of the public sector—rather it has grown. This reflects government moves to 'gate keep' the market economy.
- Similarly, while soft budget constraints have generally been tightened during the reform years, soft credit constraints operated by the state-dominated banking system have remained in place. Consequently, capital has continued to find its way into inefficient state enterprises.
- The corrupt allocation of capital has also persisted, despite a number of high-profile prosecutions in which some bankers have paid with their lives for lending in this way.

Weak Capital Markets. The undeveloped nature of Vietnam's capital market represents an additional constraint on development.

- **Banks.** Vietnamese banks dominate the capital market. These banks are generally weak and in need of reform.
 - While there is some progress towards closing and merging joint stock banks, there is little progress in tackling the high level of indebtedness among state banks.
- **Stock market.** Despite the recent opening of a stock market, there are currently just three companies listed on the stock market, and there are tight restrictions on the extent to which shares can fluctuate. Therefore it is likely to be some years before the stock market is a significant source of business capital.
- **Bonds.** Moreover, in a recent auction of five-year government bonds, there were no bidders. It had been hoped that the bonds would be traded on the stock market as an intermediate step towards its development.

Politico-Economic Policy

The Ninth Congress. Does Hanoi have any plans to change things? One opportunity was the Ninth Communist Party Congress in March

2001. This event is held once every five years and sets policy direction.

- Unfortunately, the main policy document of the Congress, the Political Report, did not contain any surprises in terms of economic reform.

Clinton's Visit. Can Washington shape things? President Clinton hoped to move Hanoi in a more market-oriented direction during his visit in November 2000.

- The visit showed a welcome readiness for Washington and Hanoi to engage each other 25 years after the war.

The Good News: A Trade Deal

Of course, the highlight of the visit was a sweeping trade agreement between the U.S. and Vietnam that took four years to negotiate. Who gets what?

- Vietnam gets improved access to the U.S. market.
- Hanoi agreed to provide foreign investors with some respite from murky approvals processes, dual pricing hurdles, and bewildering obstacles to joint ventures. This added clarity should increase foreign investor confidence.
- The pact also provides a boost for Vietnam's credibility—signaling a willingness to push ahead with urgently needed reforms.
- The trade deal also clears the way toward Vietnamese membership in the WTO.

The Bad News: No Quick Fix

But optimism about the trade deal is being tempered with pragmatism on both sides. Fact is, dramatic gains in trade and investment may well take years. Why does it take so long?

- **On the Vietnamese side,** their exporters are latecomers to the U.S market. They must set up distribution networks, and establish business relationships. They must also reduce costs, improve quality, and stabilize supply. It will take time to do all this. In short, the trade deal is bad news for Vietnamese exporters without patience.

- **On the American side**, U.S investors are still far from sold on Vietnam being a good place to do business. They see many of these negative factors as all too common.

A Divided Politburo. For instance, President Clinton encountered first-hand confirmation of the tensions that exist within the senior leadership of the Vietnamese government over the wisdom of economic reform.

- Vietnam's politburo permits only low-risk, superficial economic reform—the minimum needed to attract a first round of optimistic foreign investors.
- But its leaders are far from accepting the more radical economic freedoms needed for Vietnam to sustain strong economic growth, hold on to investors, and avoid lagging badly behind Asian competitors.
- In short, the Clinton visit confirmed the fact that Vietnam will not fling open the window to market forces anytime soon.

Modest Reforms. That said, Hanoi does deserve credit for a trade agreement (cited earlier), the opening of a small stock market in Ho Chi Minh City, and less red tape for new businesses getting a license.

- But on balance, these achievements are a modest response to a sharp decline in FDI now at one-sixth of its mid-1990s peak.
- In other words, this is not like China's boldness in its economic reforms.

Old Realities. In most ways, Vietnam's communists have not changed their economic mismanagement.

- The economic management team is just as intrusive and corrupt but more cautious than their Chinese neighbors.
- The private sector's access to credit is restricted by banks' preference to lend to party-related companies for the benefit of a rich elite.
- The party controls government, judiciary, and the media and argues that it should retain that grip for the sake of stability.

Social Unrest. As a result of the economic mismanagement, some cracks are starting to show in Vietnam's system.

- Rural poverty has led to social unrest.
- Expectations of change in the more entrepreneurial south are rising.
- It's unclear how long Hanoi can keep the lid on these pressures.

The Way Ahead. To keep Vietnam from once again becoming a source of economic and social instability, the USG should try to shape Vietnam's economic transformation.

- USG should link economic carrots to Vietnamese economic reforms.

Conclusions

Vietnam's economic performance remains well below its potential.

- A return to the rapid economic growth rates of the mid-1990s is unlikely without a recovery in foreign investment.
- Foreign investors will likely remain on the sidelines until the government speeds up economic reforms.
- Economic problems include: FDI shortfall, agricultural impasse, red tape, public sector mismanagement, and weak capital markets.
- No bold economic reforms developed at the Ninth Communist Party Congress in March 2001.
- Despite the trade deal, the Clinton visit did not move the divided Vietnamese Politburo to fling open the window to market forces.
- USG should link economic carrots to Vietnamese economic reforms.

APPENDIX A
KEY ECONOMIC INDICATORS

Economy	Population 2000 (Mil) WB/CIA	GNP (PPP-basis)		GNP (Exchange Rate-basis)		% GDP Growth		U.S. Exports 2000 (\$M) DoC	U.S. Imports 2000 (\$M)
		Per Capita 2000 (\$) WB/CIA	Total 2000 (\$B) WB/CIA	Per Capita WB/CIA/ADB	Total 2000 (\$B) WB/CIA/ADB	2000	2001		
ASIAN DEVELOPING & NIEs	3,214.273	3,546.995	11,401.009	1,052	3,381.188	6.8	5.8	135,208	299,507
1 AFGHANISTAN *	26.550	791 (a,b)	21.000	791	21.000			8.2	0.8
2 BANGLADESH	129.754	1,588	206.113	368.9	47.864	6.0	5.5	239	2,418
3 BHUTAN	0.805	1,439	1.158	605.0	0.487	6.1	n.a.	1	1
4 BRUNEI	0.328	16,378	5,372	14,774.4	4,846			156	384
5 CHINA,PR	1,261.100	3,983	5,023.239	856.4	1,079.954	8.0	7.5	16,185	100,018
6 FIJI	0.810	4,690	3,799	1,845.7	1,495	4.9	n.a.	23	147
7 FR. POLYNESIA	0.234	23,509	5,501	16,790.6	3,929			94	44
8 GUAM	0.155	20,645 (a,b)	3,200	20,645.2	3,200				
9 HONGKONG	6,798	25,247	171,631	24,016.0	163,261	10.5	0.6	14,582	11,449
10 INDIA	1,015.923	2,405	2,443.184	471.9	479,404	6.0	4.5	3,667	10,687
11 INDONESIA	210.421	3,051	641.973	728.3	153.255	4.8	3.0	2,402	10,367
12 CAMBODIA	12.021	1,429	17.176	266.8	3.207	4.0	n.a.	32	826
13 KIRIBATI	0.092	826 (a)	0.076	472.5	0.043	(1.7)	n.a.	5	1
14 KOREA,S	47.275	17,427	823,872	9,671	457,219	8.8	2.5	27,830	40,308
15 LAOS	5,216	1,596	8,325	327.6	1,709	5.7	n.a.	4	10
16 MACAU/MACAO	0.442	16,629	7,350	13,830.3	6,113			71	1,266
17 MALAYSIA	23.260	9,132	212,417	3,840.1	89,321	8.3	1.0	10,938	25,568
18 MALDIVES	0.276	5,228	1,443	1,576.1	0.435	5.6	n.a.	6	94
19 MARIANA IS., N	0.072	12,515 (a)	0.900	7,277.8	0.524			60	5
20 MARSHALL IS.	0.052	2,019 (a)	0.105	1,846.2	0.096			29	14
21 MICRONESIA, F.S.	0.118	2,034 (a)	0.240	1,932.2	0.228				
22 MONGOLIA	2.398	1,762	4,226	406.6	0.975	1.1	1.4	18	117
23 BURMA	41.735	1,526 (a,b)	63,700	1,526.3	63,700	5.5	n.a.	17	471
24 NAURU	0.012	4,981 (a,b)	0.059	4,981	0.059			4	1
25 NEPAL	23.920	1,362	32,568	227.8	5,450	6.5	n.a.	35	229
26 N. CALEDONIA	0.213	21,850	4,654	14,352.1	3,057			19	31
27 PAKISTAN *	138.080	1,921	265,228	446.6	61,673	3.9	3.9	462	2,167
28 PALAU	0.019	6,789 (a)	0.129	7,578.9	0.144			18	14
29 PNG	4,807	2,387	11,475	834.4	4,011	0.3	n.a.	23	35
30 PHILIPPINES	75.580	4,003	302,582	994.8	75,186	4.0	2.5	8,799	13,935
31 SAMOA,AM	0.065	7,640 (a,b)	0.500	7,639.9	0.500				
32 SINGAPORE	4,018	28,228	113,422	22,960	92,252	9.9	(0.2)	17,806	19,178
33 SOLOMON ISL	0.442	1,665	0.736	622	0.275	(1.0)	n.a.	6	1
34 SRI LANKA	19.360	3,503	67,815	847	16,402	6.0	n.a.	205	2,002
35 THAILAND	60.728	6,406	389,018	2,008	121,927	4.4	2.0	6,618	16,385
36 TONGA	0.100	2,250 (a)	0.225	1,540	0.154	1.5	n.a.	8	5
37 TUVALU (99est)	0.011	1,070 (a,b)	0.012	1,070	0.012				
38 VANUATU	0.200	3,165	0.633	1,205	0.241	4.0	n.a.	1	1
39 VIETNAM	78.523	2,026	159,094	399	31,344	5.5	4.5	368	821
40 SAMOA W.	0.169	5,083	0.859	1,396	0.236	6.8	n.a.	64	6
41 TAIWAN	22.191	17,394 (a,b)	386,000	17,394	386,000	6.0	(1.0)	24,406	40,503
INDUSTRIAL CTYS									
42 US	281,550	34,260	9,645,916	35,102	9,882,842	4.1	1.3	-	-
43 CANADA *	30.735	28,199	866,685	22,435.3	689,549	4.4	2.0	178,941	230,838
44 JAPAN	126.770	26,172	3,317,763	36,894.4	4,677,099	1.5	(0.5)	64,924	146,479
45 AUSTRALIA	19.195	26,129	501,548	20,527.4	394,023	3.8	2.3	12,487	6,444
46 NEW ZEALAND	3.831	20,336	77,907	13,047.0	49,983	3.7	1.8	1,982	2,086
OTHER COUNTRIES									
47 RUSSIA *	145.542	8,396	1,222,013	1,725.2	251,092	8.3	4.0	2,092	7,659
48 N. KOREA	21,688	1,014 (a,b)	22,000	1,014	22,000	-3.1.3		3	0
49 COMOROS	0.558	1,493	0.833	362.0	0.202	(1.1)	n.a.	0.7	3.5
50 MADAGASCAR	15.523	832	12,922	259.0	4,020	4.8	n.a.	15.4	157.8
51 MAURITIUS	1.186	10,018	11,881	3,795	4,501	3.6	n.a.	23.9	285.9
52 SEYCHELLES	0.081	7,415	0.601	7,679.0	0.622	1.2	n.a.	7.1	8.1
* Not in USPACOM area	(a) - CIA "World Factbook," PPP est.; (b) - Exch. est not available (PPP used)								
SUMMARY									
4 NIEs	80,282	18,621	1,494,925	13,686	1,098,732			84,624	111,438
SE ASIA(w/o Singapore)	466,077	3,725	1,735,957	1,032	480,795			29,316	68,296
S. ASIA	1,396,403	2,222	3,102,209	499	696,415			4,640	18,069
PACIFIC IS.	7,499	4,294	32,203	2,358	17,680			358	304
N.KOREA	21,688	1,014	22,000	1,014	22,000			3	0
ASIA-PACIFIC REGION	3,385,757	4,525	15,320,227	2,518	8,524,293			214,604	454,516
INDIAN OCEAN	17,348	1,512	26,237	539	9,345			47	455
USPACOM	3,238,475	4,650	15,060,235	2,610	8,450,965			214,181	452,804
WORLD	6,054,431	7,610	45,219,226	5,338	31,848,813			781,917	1,218,022
MEMO:									
ASEAN(10)	511,830	3,738	1,913,079	1,244	636,747			47,139.1	87,944.7
MEXICO	97,966	9,035	885,127	5,864.4	574,512	6.9	0.8	111,349	135,926
CHILE	15.211	9,427	143,390	4,648.6	70,710	5.4	4.0	3,460	3,269
PERU	25,661	4,864	124,824	2,099.8	53,882	3.1	0.5	1,659,90	1,994,90
APEC (21)	2,350,736	10,043	23,608,538	8,097	19,034,566			507,061	814,954
EUROPEAN UNION	457,558	21,373	9,779,522	18,319	8,381,936	3.4	1.8	165,065	220,019
MID. EAST	245,923	5,330	1,310,883	2,941	723,316			19,006	38,962
W. HEMIS. DEVEL.	517,446	7,245	3,748,769	3,913	2,024,864	4.2	1.7	59,283	73,348

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